PETITION AND TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1931

No. 26

THE UNITED STATES, PETITIONER

vs.

KIRBY LUMBER COMPANY

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED FEBRUARY 28, 1931
CERTIORARI GRANTED APRIL 20, 1931
(35681)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1930

No. 759

THE UNITED STATES, PETITIONER

vs.

KIRBY LUMBER COMPANY

ON PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS

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1 In the Supreme Court of the United States

October Term, 1930

No. 759

THE UNITED STATES, PETITIONER

v.

KIRBY LUMBER COMPANY

Petition for a Writ of Certiorari to the Court of Claims

The Solicitor General, on behalf of the United States, prays that a writ of certiorari issue to review the judgment of the Court of Claims in the above case rendered December 1, 1930. The opinion of the Court of Claims is reported in 44 F. (2d) 885.

Statutes and Regulations Involved

The revenue act of 1921 (c. 136, 42 Stat. 227, 237, 254) provides:

"SEC. 233. (d) That in the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in sections 213 * * *

"SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

"(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations,
2 trades, businesses, commerce, *or sales, or dealings in property*, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever.* * * *" (Italics ours.)

Articles 50 and 545, Regulations 62, promulgated under the revenue act of 1921, provide:

"ART. 50. Forgiveness of indebtedness.—The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect. It may amount to a payment of income or to a gift or to a capital transaction. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor, and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. * * *

"ART. 545. Sale and retirement of corporate bonds.—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (c). If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

* * * * * * *

STATEMENT

The Kirby Lumber Company, a Texas corporation, on July 16, 1923, mortgaged its property to secure the payment of certain
3 bonds, $12,126,800 par value of which were issued on that date. (Findings 1, 4.) For these bonds the Lumber Company received cash at par for each bond. (Finding 7.)

During the same year, 1923, the Kirby Lumber Company purchased and retired bonds of this issue aggregating $1,078,300 par value for $940,778.70, or $137,521.30 less than what the company received for the same bonds in the same year. (Finding 5.)

On March 13, 1924, the Kirby Lumber Company filed its income tax return for the calendar year 1923, disclosing a tax liability of $188,062.24. (Finding 2.) Included in this return was $124,446.45 of the sum of $137,521.30. (Finding 6.) Thereafter, on February 16, 1928, the Commissioner of Internal Revenue made an additional assessment against the lumber company for 1923 of $8,047.05. (Finding 3.) In this assessment the commissioner included, as subject to tax, an additional sum of $13,074.85, being the difference between $137,521.30 and $124,446.45. (Finding 6.) There was thus included in the respondent's taxable income for 1923 the entire sum of $137,521.30, representing the difference between the issuing price and the repurchase price of the bonds bought back by the taxpayer in 1923. (Finding 6.)

A claim for refund of $17,188.99 was duly filed on the ground that the sum of $137,521.30 was not taxable gain to the Kirby Lumber Company. (Finding 8.) This claim was rejected, (Finding 9),
4 and thereupon the respondent brought suit in the Court of Claims. That court, basing its decision upon Bowers v. Kerbaugh-Empire Co., 271 U. S. 170, held that the respondent was entitled to recover the sum of $17,188.99.

QUESTION PRESENTED

Whether a corporation which sells its own bonds for par, and during the same year purchases back some of the same bonds for less than par and retires them, thereby realizes a taxable gain under the revenue act of 1921.

SPECIFICATION OF ERRORS

The court below erred:

1. In holding that the gain resulting from the sale and retirement of the respondent's bonds was not taxable as income;

2. In giving judgment for the respondent.

REASONS FOR GRANTING THE WRIT.

1. The court below conceded that the respondent derived a gain from buying back and retiring its bonds at less than the issuing price, but held upon the authority of Bowers *v.* Kerbaugh-Empire Co., 271 U. S. 170, that that gain did not constitute taxable income. We submit that the court below erroneously construed the case cited. In that case the taxpayer, before the war, borrowed money which it agreed to repay in German marks. This money was used in its business and lost. In 1921 the taxpayer repaid the loan, but in the mean time the value of the mark had depreciated greatly. The difference in the value of the marks borrowed at the time of the loan and at the time of the repayment was approximately $700,000. The taxpayer's losses, in the transactions for which the money was borrowed, exceeded that amount. Because the borrowed money had been consumed in the business loss, this court there held that the mere diminution of this loss did not constitute taxable income. The court emphasized the fact that "the result of the whole transaction was a loss," and stated (p. 175):

"The contention that the item in question is cash gain disregards the fact that the borrowed money was lost and that the excess of such loss over income was more than the amount borrowed. When the loans were made and notes given the assets and liabilities of defendant in error were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if the marks had not declined in value; but the mere diminution of loss is not gain, profit, or income."

We submit that the Kerbaugh-Empire decision is not applicable to the instant case. Here, as a result of the issuance and repurchase of its bonds, the taxpayer made a conceded gain. When the respondent issued its bonds at par its assets and liabilities were increased in equal amounts. When it bought back its bonds at less than par its liabilities were decreased by the face value of the bonds, but its assets were decreased only by what it paid for the bonds. In the instant case there was no loss but on the contrary a clear profit. This gain was represented by actual cash in the respondent's treasury.

That the application of the *Kerbaugh-Empire Company case* to the question here presented was erroneous is clearly indicated by the language of this court in Burnet, Commissioner, *v.* Sanford &

Brooks Company, No. 31, October term, 1930, decided January 5, 1931 (not yet reported), where, referring to the Kerbaugh-Empire Company case, this court said:

"In that case the taxpayer, which had lost in business, borrowed money, which was to be repaid in German marks, and which was later paid in depreciated currency, *had neither made a profit on the transaction nor received any money or property which could have been made subject to the tax.*" (Italics ours.)

In the instant case there is both (1) a clear gain or profit and (2) actual cash received during the year in excess of disbursements made or incurred.

2. The decision of the court below is in conflict with administrative rulings and regulations of long standing and which have acquired legislative sanction by acquiescence. Article 545 of Regulations 62, *supra*, expressly provides that if a corporation purchases and retires bonds issued at par for a price less than par, the excess of the issuing price over the purchase price is income. This regulation was first issued as article 544 of Regulations 45, promulgated under the revenue act of 1918. It has been reissued as article 545 of Regulations 62, promulgated under the 1921 act, as article 545 of Regulations 65, promulgated under the 1924 act, as article 545 of Regulations 69, promulgated under the 1926 act, and as article 68 of Regulations 74, promulgated under the 1928 act. Since the regulations in question permit the corporation to deduct the loss where bonds are issued and then repurchased at a price in excess of the issuing price, it is submitted that they deal with the matter comprehensively and reasonably. Under these circumstances they have the force and effect of law and should not be disturbed except for weighty reasons. Fawcus Machine Company *v.* United States, No. 40, October term, 1930, decided January 5, 1931; National Lead Co. *v.* United States, 252 U. S. 140.

3. The question is one of importance in the administration of the tax laws. A large number of cases raising the precise point here involved are now pending in the Internal Revenue Bureau. A careful review of these cases indicates that the amount of taxes involved approximates $10,000,000. Although the opinion below represents the first court decision on the question presented, the Board of Tax Appeals, upon the authority of the Kerbaugh-Empire case, has decided a number of cases in accordance with the decision in the instant case, the first of these being Independent Brewing Company of Pittsburgh, 4 B. T. A. 870. The Government has not acquiesced in these decisions, and appeals have been taken in Kirby Lumber Company, 9 B. T. A. 1048, and American Tobacco Company, 20 B. T. A. 586, to the Circuit Court of Appeals for the Fifth and Second Circuits, respectively. There are pending in various district courts at least ten cases involving the same question. Until the question is finally determined there will be many suits to recover taxes assessed in accordance with the regulations. It will relieve the dockets of the lower Federal courts of the cases already begun and of those about to be begun if the writ issues.

4. Somewhat analogous questions were presented in Great Northern Ry. Co. v. Lynch, 292 Fed. 903 (D. Minn.) and Commissioner v. Simmons Gin Co., 43 F. (2d) 327 (C. C. A. 10th), which cases are not harmonious with the instant case, but we have found no conflict of decisions upon the question here involved.

CONCLUSION

It is respectfully submitted that this petition should be granted.

THOMAS D. THACHER,
Solicitor General.

Per W. M. S.

FEBRUARY, 1931.

In the Court of Claims

No. L-52

KIRBY LUMBER COMPANY, PLAINTIFF

vs.

THE UNITED STATES, DEFENDANT

I. *Petition*

Filed February 25, 1930

To the honorable the Chief Justice and the Judges of the Court of Claims:

I

The plaintiff, the Kirby Lumber Company, is a corporation organized and existing under the laws of the State of Texas, with its principal office at 911-915 Main Street, Houston, Texas.

II

Within the time prescribed by law the plaintiff duly filed with the collector of internal revenue at Austin, Texas, an income tax return for the calendar year 1923, and paid the tax shown thereon to be due.

III

On July 16, 1923, the Kirby Lumber Company made a deed
10 of trust or mortgage on certain of its property to the Miners Bank of Wilkes-Barre, Wilkes-Barre, Pennsylvania, trustee, to secure the payment of certain bonds aggregating the total prin-

cipal sum of $14,000,000 which were to be issued July 16, 1923. Although the deed of trust or mortgage authorized the issue of $14,000,000 in bonds, only $12,126,800 were actually issued. The article in the deed of trust or mortgage describing the said issue is as follows:

Article I

Concerning the Bonds

Section 1. The bonds to be issued hereunder shall be in denominations of one hundred ($100.00) dollars, five hundred ($500.00) dollars, and one thousand ($1,000.00) dollars, respectively. All bonds issued shall be numbered consecutively from 1 to 15150, both inclusive. Bonds numbers 1 to 1000, both inclusive, shall be of the denomination of one hundred ($100.00) dollars each; bonds numbers 1001 to 1500, both inclusive, shall be of the denomination of five hundred ($500.00) dollars each; bonds numbers 1501 to 15150, both inclusive, shall be of the denomination of one thousand ($1,000.00) dollars each. All bonds are of like tenor, terms and effect; are dated July 16, A. D. 1923, and are due and payable at the First National Bank of Houston, Houston, Texas, on the 16th day of July, A. D. 1938. They bear interest at the rate of six per cent (6%) per annum, interest payable semiannually on the 16th day of January and the 16th day of July, in each year, and coupons for the several installments of interest are attached to the respective bonds, and each bond shall be authenticated by the trustee, and contain a form for the registration thereof, all of which shall be in substantially the following form, to wit:

11 (Form of bond)

United States of America

State of Texas

No. —— $100.00 ($500.00) ($1,000.00) (The correct denomination of each bond will be set at the proper space.)

Kirby Lumber Company First Mortgage Six Per Cent Sinking Fund Gold Bond

Kirby Lumber Company, a corporation created under the laws of the State of Texas, with its domicile in the city of Houston, in Harris County, Texas (hereinafter called company), acknowledges itself to be indebted and, for value received, hereby promises to pay to the bearer hereof (or in case this bond be registered, to the registered owner hereof), the sum of one hundred ($100.00) dollars ($500.00) ($1,000.00) (correct denomination of each bond will be

inserted here) in gold coin of the United States of America, of or equal to the present standard of weight and fineness, on the sixteenth day of July, A. D. 1938, together with interest thereon from the sixteenth day of July, A. D. 1923, at the rate of six per cent per annum, payable in like gold coin, semi-annually, on the sixteenth day of January and the sixteenth day of July in each year, until the principal sum shall be paid, interest payable on presentation and surrender of the interest coupons hereto attached as they severally mature. The principal hereof is payable at the office of the First National Bank of Houston, Houston, Texas, upon presentation and surrender of this bond, when drawn or at its maturity. The interest hereon is payable at the office of the New York Trust Company of New York, in the city of New York, or at the holder's option at the
12 First National Bank of Houston, Houston, Texas, upon presentation and surrender of the respective coupons hereto attached as they severally mature.

This bond is one of a series of fifteen thousand, one hundred and fifty bonds issued by the company, and numbered consecutively from 1 to 15,150, both inclusive, bonds numbered 1 to 1,000, both inclusive, being for the sum of one hundred dollars each, and bonds numbered 1,001 to 1,500, both inclusive, being for the sum of five hundred dollars each, and bonds numbered 1,501 to 15,150, both inclusive, being for the sum of one thousand dollars each; all of like tenor, terms, date, and effect, differing only as to amount, and aggregating the total principal sum, par value, of fourteen million ($14,000,000.00) dollars. All of said bonds are equally secured by a deed of trust or mortgage dated the 16th day of July, A. D. 1923, made by the company to Miners Bank of Wilkes-Barre, Wilkes-Barre, Pennsylvania, as trustee; and for the description of the property thereby mortgaged, the nature and extent of the security and the rights of the holders of the bonds issued thereunder, reference is hereby made to said mortgage or deed of trust, with the same force and effect as if the provisions thereof were herein fully set forth.

The right is hereby reserved to the company to draw, by lot, from time to time, outstanding bonds, on any semi-annual interest date, and to redeem the same by the payment of the principal of such bonds and accrued interest thereon, plus a premium of two per cent on the principal thereof, upon giving thirty (30) days' notice, by publication in some newspaper of general circulation, published in the city of New York, and by depositing in the First National Bank of Houston, Houston, Texas, to be used for that purpose only, the amount necessary to pay the principal, premium and interest in full of each bond so drawn, on or before the advertised date of such payment. The company likewise reserves the right to redeem all bonds at any time outstanding, upon any semi-annual interest date
13 upon like advertisement, by payment therefor at par and accrued interest, plus five per cent on the principal of such bonds.

This bond shall not be valid or obligatory for any purpose unless and until authenticated as one of the series of bonds herein described

by a certificate endorsed hereon and executed by the trustee, or its successor in trust.

This bond shall pass by delivery, and be payable to the bearer hereof, unless registered in the owner's name on the registration books kept at the office of the New York Trust Company of New York, as registrar, in the city of New York. Such registration shall be noted on the bond by said registrar, after which no transfer hereof shall be valid unless made on the books of the registrar by the registered owner hereof, in person or by his attorney duly authorized, and similarly noted on the bond. This bond, however, may be discharged from registration by being transferred in the manner aforesaid to the bearer, by notation hereon by the registrar, after which it shall be transferable by delivery; but may again be registered or discharged from registration as before, and as often as the owner may desire. The interest coupons hereon, however, shall continue negotiable and transferable by delivery, and payable to bearer, notwithstanding any registration hereof.

In witness whereof, Kirby Lumber Company has caused these presents to be signed in its corporate name, by its president, its corporate seal to be hereto affixed, to be attested by its secretary, and the interest coupons hereto attached to be authenticated by the facsimile signature of its treasurer, as of the sixteenth day of July, A. D. 1923.

KIRBY LUMBER COMPANY,
By _____
President.

Attest:

_____
Secretary.

14 (Form of interest coupon)

No. _____ $3.00 ($15.00) ($30.00)
(Correct amount will be inserted in each coupon)

On the sixteenth day of January, A. D. 1924 (correct date of payment will be inserted in each coupon), Kirby Lumber Company will pay to the bearer hereof, at the office of the New York Trust Company of New York, in the city of New York, or, at the option of the holder hereof, at the First National Bank of Houston, in the city of Houston, Texas, three ($3.00), (fifteen) ($15.00), (thirty) ($30.00) (correct amount will be set out in each coupon), dollars in gold coin, being six months' interest then due on its first mortgage six per cent sinking fund gold bond No. ——.

_____
Treasurer.

15 (Form of trustee's certificate

Trustee's Certificate

Office of
Miners Bank of Wilkes-Barre,
Wilkes-Barre, Pennsylvania.

This is to certify that this bond is one of the series of 15,150 bonds, numbered from 1 to 15,150, both inclusive, mentioned in the trust deed or mortgage referred to in this bond.

MINERS BANK OF WILKES-BARRE,
Wilkes-Barre, Pa.,
Trustee,

By ----------
Vice President.

(Form of registration)

(No writing hereon except by the New York Trust Company of New York, registrar, or by its successor)

Date of registration	In whose name registered	Registrar
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----------	----------	----------
----------	----------	----------

16 IV

The bonds mentioned in Paragraph III above were dated July 16, 1923, and were issued at par.

V

During the year 1923 the Kirby Lumber Company purchased certain of these bonds at less than par, which was also the issue price, and retired them. The amount of the bonds so retired, and the amount paid for them by the Kirby Lumber Company, are as follows:

Par value (issue price)	Paid for bonds	Difference
$1,078,300.00	$940,788.07	$137,511.93

VI

On or about January 24, 1928, the plaintiff filed with the Collector of Internal Revenue at Austin, Texas, a claim for the refund of $17,188.99, or such greater amount as is legally refundable. The said claim for refund was based on the ground that the difference between the issue price of the bonds retired and the price the plaintiff paid therefor is not taxable gain to the plaintiff.

VII

On May 8, 1928, the Deputy Commissioner of Internal Revenue wrote the plaintiff that "The claim will, therefore, be rejected. The rejection of the claim will officially appear on the next schedule to be approved by the Commissioner."

17

VIII

By reason of the action of the Commissioner of Internal Revenue in refusing to refund to the plaintiff the sum of seventeen thousand one hundred eighty-eight dollars and ninety-nine cents ($17,188.99), together with interest from the date of payment, the whole of the said amount plus interest is now wrongfully and unlawfully withheld from the plaintiff without its consent and against its will by the United States.

IX

No other action has been had on said claim in Congress or by any of the departments; no other person than the plaintiff is the owner thereof or interested therein; no assignment or transfer of this claim, or any part thereof or interest therein, has been made; plaintiff is justly entitled to the amount herein claimed from the United States after allowing all just credits and offsets. The plaintiff has at all times borne true faith and allegiance to the Government of the United States, and has not in any way voluntarily aided, abetted, or given encouragement to rebellion against the said Government.

Wherefore the plaintiff asks judgment against the United States in the sum of seventeen thousand one hundred eighty-eight dollars and ninety-nine cents ($17,188.99) plus interest thereon from the date of payment.

KIRBY LUMBER COMPANY,
By ROBERT ASH,
THOMAS J. REILLY,
Attorneys for Plaintiff,
Munsey Building, Washington, D. C.

18 [*Duly sworn to by C. H. Rhoads; jurat omitted in printing.*]

19 II. *General traverse*

Filed April 5, 1930.

And now comes the Attorney General, on behalf of the United States, and answering the petition of the plaintiff herein denies each and every allegation therein contained; and asks judgment that the petition be dismissed.

CHARLES B. RUGG,
Assistant Attorney General.

III. *Argument and submission of case*

On October 16, 1930, this case was argued and submitted on merits by Mr. Thomas J. Reilly, for the plaintiff, and by Mr. Assistant Attorney General Charles B. Rugg, for defendant.

20 IV. *Special findings of fact, conclusion of law and opinion of the court by Williams, J.*

Filed December 1, 1930

Mr. Thomas J. Reilly for plaintiff. *Mr. Robert Ash* was on the brief.

Mr. Assistant Attorney General Charles B. Rugg for defendant. *Messrs. Fred K. Dyer* and *William E. Davis* were on the brief.

The plaintiff in this case during the taxable year 1923, issued its own bonds at par and subsequently within the year, purchased and retired certain of the said bonds, so issued, at a price less than the issuing price.

The excess of the issuing price over the purchase price of the said bonds was the sum of $137,521.30.

The issue in the case is whether or not this item, $137,521.30, was taxable as income to the plaintiff for the year in question.

This case having been heard by the Court of Claims upon a stipulation of facts, signed on behalf of plaintiff by its attorney, Mr. Robert Ash, and on behalf of the defendant by Assistant Attorney General Charles B. Rugg, and the evidence, the court makes the following

Special findings of fact

1. The plaintiff, the Kirby Lumber Company, is a corporation organized and existing under the laws of the State of Texas, with its principal office at 911–915 Main Street, Houston, Texas.

2. The plaintiff on or about March 13, 1924, filed with the collector of internal revenue at Austin, Texas, its income-tax return for the calendar year 1923 disclosing a tax liability of $188,062.24, which was duly paid.

3. On February 16, 1928, the Commissioner of Internal Revenue made an additional assessment in the sum of $8,047.05 for the year 1923, which was duly paid.

4. On July 16, 1923, the Kirby Lumber Company made a deed of trust or mortgage of certain of its property to secure the payment of certain bonds, aggregating the total principal sum of $14,000,000. Although the deed of trust authorized the issue of $14,000,000 in bonds, only $12,126,800 were actually issued and they were issued at par on July 16, 1923.

5. During the year 1923, the Kirby Lumber Company purchased $1,078,300 par value of these bonds for $940,778.70, or $137,521.30 less than the issuing price, and retired the said bonds so purchased.

6. In its return referred to in Finding 2, the taxpayer included $124,446.45 of the $137,521.30, referred to in Finding 5, as a
21 portion of its income for the year 1923, and in the said additional assessment for the year 1923 the commissioner included as an additional amount of income, subject to tax for said year, an additional sum in the amount of $13,074.85 on account of the purchase of bonds at less than the issuing price; so that there was included in plaintiff's taxable income for the year 1923 the said sum of $137,521.30 referred to in Finding 5.

7. The bonds mentioned in Finding 4 above were issued at par, the Kirby Lumber Company receiving the par value of the bonds issued, without incurring expense incident to the issue of the said bonds.

8. On or about January 24, 1928, the plaintiff filed with the collector of internal revenue at Austin, Texas, a claim for refund of $17,188.99, or such greater amount as is legally refundable. The said claim for refund was based on the ground that the difference between the issuing price of the bonds retired and the price at which they were subsequently acquired by the plaintiff was not taxable gain to the plaintiff.

9. On May 8, 1928, the Deputy Commissioner of Internal Revenue wrote the plaintiff that, "The claim will, therefore, be rejected. The rejection of the claim will officially appear on the next schedule to be approved by the commissioner."

Conclusion of law

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that the plaintiff is entitled to recover the sum of $17,188.99.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of seventeen thousand one hun-

dred eighty-eight dollars and ninety-nine cents ($17,188.99), with interest at the rate of six per cent per annum from the dates of payments thereof to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of subsection (b), section 177 of the Judicial Code, being a part of the revenue act of May, 1928.

Opinion

WILLIAMS, Judge, delivered the opinion of the court:

The plaintiff brings this suit to recover $17,188.99, income taxes which it claims were erroneously assessed against it for the calendar year 1923.

The plaintiff during the taxable year issued its own bonds at par, and later within the year purchased on the open market certain of these bonds at less than par, and retired them. The difference between the par value of such bonds and the price at which they were purchased and retired was the sum of $137,521.30.

The question before the court for determination is this, namely, is the $137,521.30 the excess of the issuing price of the bonds over the purchase price a taxable gain or income to the plaintiff for the year 1923.

Article 545 of Treasury Regulations 62 provides:

"Sale and retirement of corporate bonds.—(1) (a) If bonds are issued by a corporation at their face value, the corporation
22 realizes no gain or loss. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

In conformity with the regulations the Commissioner of Internal Revenue determined that the excess of the issuing price of the bonds over the purchase price represented taxable income to the plaintiff and assessed and collected the taxes in question.

The plaintiff contends that the item in controversy is not taxable as income because it was not gain derived from either capital or labor, or from both combined, or through a sale or conversion of capital, and cites in support of its contention a long line of decisions of the Board of Tax Appeals, which decisions are premised on Bowers *v.* Kerbaugh-Empire Co., 271 U. S. 170–174.

In the Kerbaugh-Empire case, supra, the defendant in error had before the World War borrowed money from a bank in Germany, repayable in marks or their equivalent in gold coin of the United States.

A subsidiary of the defendant in error, for whose use the money was borrowed, lost the money in business and claimed, and was allowed, a loss of such amounts in its income-tax returns for the years in which the losses occurred.

In 1921 the defendant in error made payment of the balance due on its notes. Owing to the depreciated value, at that time, of the German mark there was, measured by United States gold coin, a difference between the value of the marks borrowed at the time the loans were made and the amount paid in liquidation of the unpaid balance the sum of $684,456.18.

The Commissioner of Internal Revenue treated this sum of $684,456.18 as income for the year 1921 and assessed taxes thereon. The Supreme Court held that it was not taxable as income. The court stated the issue to be:

"The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the custodian and the value when the loans were made was income."

The court then said:

"The sixteenth amendment declares that Congress shall have power to levy and collect taxes on income, 'from whatever source derived,' without apportionment among the several States and without regard to any census or enumeration.

* * * * * * *

"* * * 'Income' has been taken to mean the same thing as used in the corporation excise tax act of 1909, in the sixteenth amendment and in the various revenue acts subsequently passed. Southern Pacific Co. *v.* Lowe, 247 U. S. 330, 335; Merchants L. & T. Co. *v.* Smietanka, 255 U. S. 509, 519. After full consideration, this court declared that income may be defined as gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital. Stratton's Independence *v.* Howbert, 231 U. S. 399, 415; Doyle *v.* Mitchell Brothers Co., 247 U. S. 179, 185; Eisner *v.* Macomber, 252 U. S. 189, 207. And that definition has been adhered to and applied repeatedly. See e. g. Merchant L. & T. Co. *v.* Smietanka, supra, 518; Goodrich *v.* Edwards, 255 U. S. 527, 535; United States *v.* Phellis, 257 U. S. 156, 169; Miles *v.* Safe Deposit Co., 259 U. S. 247, 252–253; United States *v.* Supplee-Biddle Co., 265 U. S. 189, 194; Irwin *v.* Gavit, 268 U. S. 161, 167; Edwards *v.* Cuba Railroad, 268 U. S. 628, 633. In determining what constitutes income substance rather than form is to be given controlling weight. Eisner *v.* Macomber, supra, 206."

23

Counsel for the Government contend that the decision in this case does not support the position of the plaintiff in the instant case. It is urged that the decision is "authority for the proposition that when A borrows money and loses, through business reverses, the entire amount of money borrowed, any subsequent settlement with the lender whereby A is enabled to liquidate his obligation for

less than its face amount, the difference between the amount paid to liquidate the obligation and the face amount of the obligation is not income."

Counsel say:

"It is conceivable that had the Kirby Lumber Company been insolvent when it purchased the bonds in question at a discount on the issuing price, the decision of the Supreme Court in the Kerbaugh-Empire Company case might be authority to sustain its position that the transaction resulted in no taxable gain; but, so far as the record in this case discloses, such were not the facts."

We can not agree with the contentions of counsel for the defendant. It is obvious that where a person issues obligations and afterwards redeems such obligations at a price less than that of their issue, such person derives gain through the transaction. The question is whether such gain is taxable as income. In our opinion the question whether the person engaging in such transaction is solvent or insolvent, or whether he made a profit or suffered a loss through the use of the money for which the obligations were issued is wholly immaterial.

That this was the view of the Supreme Court in the Kerbaugh-Empire case is unmistakably shown in the court's precise and explicit statement of the issue. Had the factors urged by the defendant been considered material to the determination of the case they would undoubtedly have been included by the court in its statement of the issue.

We think the decision in the Kerbaugh-Empire case fully sustains the contentions of plaintiff in the instant case that the excess of the issuing price of its bonds over the purchasing price of such of its bonds as it purchased subsequent to issue, is not taxable as income, and that the taxes herein were erroneously assessed and collected.

Judgment is therefore awarded the plaintiff in the sum of $17,188.99, with interest thereon as is by law provided. It is so ordered.

WHALEY, Judge; LITTLETON, Judge; GREEN, Judge; and BOOTH, Chief Justice, concur.

21

V. *Judgment*

At a Court of Claims held in the city of Washington on the 1st day of December, A. D., 1930, judgment was ordered to be entered as follows:

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that the plaintiff is entitled to recover the sum of $17,188.99.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of seventeen thousand one hundred eighty-eight dollars and ninety-nine cents ($17,188.99), with interest at the rate of six per cent per annum from the dates of pay-

ments thereof to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of subsection (b), section 177 of the Judicial Code, being a part of the revenue act of May, 1928.

25 [Clerk's Certificate to foregoing transcript omitted in printing.]

[Indorsement on cover:] File No. 35,681. Court of Claims. Term No. 759. The United States, petitioner *v.* Kirby Lumber Company. Petition for a writ of certiorari and exhibit thereto. Filed February 28, 1931. File No. 35,681.

U. S. GOVERNMENT PRINTING OFFICE: 1931

Supreme Court of the United States

Order allowing certiorari

Filed April 20, 1931

The petition herein for a writ of certiorari to the Court of Claims is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

U. S. GOVERNMENT PRINTING OFFICE: 1931

APR 7
CHARLES ELMORE

FILE COPY

No. 26

In the Supreme Court of the United States

OCTOBER TERM, 1930

THE UNITED STATES, PETITIONER

v.

KIRBY LUMBER COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

REPLY BRIEF FOR THE UNITED STATES

In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 759

THE UNITED STATES, PETITIONER

v.

KIRBY LUMBER COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

REPLY BRIEF FOR THE UNITED STATES

On page 9 of the respondent's brief in opposition it is contended that the petition misstates a material fact and that it is misleading. Reference is made to the statement on page 2 of the petition that "the Lumber Company received cash at par for each bond." The respondent states that the bonds were not issued *for cash*, but for its own preferred stock and accrued dividends thereon. There is nothing in the record to sustain the respondent's allegation.

We submit that the statement above quoted from the petition is a fair interpretation of the special findings of fact of the Court of Claims.

The Court of Claims in its special findings speaks of the repurchase of the bonds "at less than the issuing *price*" (Finding 5, R. 12), and finds that:

> The bonds mentioned in Finding 4 above were issued at par, the Kirby Lumber Company receiving the par value of the bonds issued, without incurring expense incident to the issue of the said bonds. (Finding 7, R. 12.)

In the findings of fact and opinion of the Court of Claims there are frequent references to "the excess of the issuing *price* of the bonds" (R. 13, 15) over "the purchase *price*" (R. 12, 13). Clearly the court considered that the respondent received *cash* for the bonds.

Throughout the proceedings in the Court of Claims it was assumed by all parties that the bonds were issued at par *for cash*. The taxpayer never urged the contrary. It was stated by the Government's counsel during argument in the Court of Claims that the bonds were issued for cash. That statement was not challenged. We submit that the statement made in the Government's petition is accurate and that the criticism and characterization of this statement contained in respondent's brief is groundless.

Moreover, whether the respondent received cash for the bonds is immaterial, since in some form the

price received was "the par value of the bonds issued."

Respectfully submitted.

THOMAS D. THACHER,
Solicitor General.
CHARLES B. RUGG,
Assistant Attorney General.
PAUL D. MILLER,
BRADLEY B. GILMAN,
Attorneys.

APRIL, 1931.

U. S. GOVERNMENT PRINTING OFFICE: 1931

FILED
MAY 18 1931
CHARLES ELMORE CROPLEY
CLERK

FILE COPY

No. [redacted]

In the Supreme Court of the United States

OCTOBER TERM, 1930

THE UNITED STATES, PETITIONER,

v.

[redacted] COMPANY.

BRIEF FOR THE UNITED STATES IN OPPOSITION TO THE [redacted]

In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 759

THE UNITED STATES, PETITIONER

v.

KIRBY LUMBER COMPANY

BRIEF FOR THE UNITED STATES IN OPPOSITION TO THE MOTION TO REMAND

Certiorari was granted in this case on April 20, 1931. The respondent now moves to have the case remanded to the Court of Claims for "a finding with reference to the consideration received by the Kirby Lumber Company for the bonds issued by it in 1923."

Although respondent's motion is described as one "to remand * * * for further findings," it is not suggested that there was any evidence before the Court of Claims upon which the finding sought may be predicated. The respondent seeks to have the case remanded to the Court of Claims and there reopened for the introduction of additional evidence. The motion is thus, in essence, one for a new trial.

The findings of the Court of Claims, which are in the precise language of the stipulation of facts adopted by the parties, expressly declare that the Kirby Lumber Company received the "par value of the bonds issued." (Finding 7, R. 12.) In view of this fact we submit that it is immaterial whether the respondent received cash or securities for the bonds.

Respectfully submitted.

THOMAS D. THACHER,
Solicitor General.
CHARLES B. RUGG,
Assistant Attorney General.
PAUL D. MILLER,
BRADLEY B. GILMAN,
Attorneys.

MAY, 1931.

U. S. GOVERNMENT PRINTING OFFICE: 1931

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No. 26

THE UNITED STATES, PETITIONER

v.

KIRBY LUMBER COMPANY

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (R. 13) is reported in 44 F. (2d) 885.

JURISDICTION

The judgment of the Court of Claims was entered December 1, 1930. (R. 15.) The petition for a writ of certiorari was filed February 28, 1931, and the writ was granted April 20, 1931. (R. 16.) The jurisdiction of this Court rests on Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether a corporation which sells its own bonds for par, and during the same year purchases some of the same bonds for less than par and retires them, thereby realizes a taxable gain amounting to the difference between the par value and the purchase price, under the Revenue Act of 1921.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in Appendix A, *infra* pp. 20–22.

STATEMENT

The Kirby Lumber Company, a Texas corporation, on July 16, 1923, mortgaged its property to secure the payment of certain bonds, $12,126,800 par value of which were issued by it on that date. (Finding 1, 4; R. 11, 12.) The Kirby Lumber Company received the par value of the bonds issued [1] without incurring expense incident to this issue. (Finding 7, R. 12.)

---

[1] The Court of Claims adopted the stipulation of counsel in its findings of fact and found (Finding 7, R. 12) that the bonds "were issued at par, the Kirby Lumber Company receiving the par value of the bonds issued." Counsel for the respondent now states (Brief in Opposition, p. 9) that the bonds were issued with cash to preferred stockholders in order to retire the preferred stock and pay the dividends due upon it. The Government maintains that this does not alter the legal effect of the transaction so far as the present question is concerned. In any case, the Lumber Company received valuable consideration equal to the par value of the bonds. Upon issuing them, its assets and liabilities were increased in equal amounts.

During the same year, 1923, the Lumber Company purchased and retired bonds of this issue aggregating $1,078,300 par value for $940,778.70, or $137,521.30 less than the amount which the Company received for the same bonds in that year. (Finding 5, R. 12.)

On March 13, 1924, the Lumber Company filed its income tax return for the calendar year 1923, disclosing a tax liability of $188,062.24. (Finding 2, R. 12.) Included in this return was $124,446.45 of the above sum of $137,521.30. (Finding 6, R. 12.) Thereafter, on February 16, 1928, the Commissioner of Internal Revenue made an additional assessment for 1923 of $8,047.05. (Finding 3, R. 12.) In making this assessment the Commissioner included, as subject to tax, the additional sum of $13,074.85, being the difference between $137,521.30 and $124,446.45. (Finding 6, R. 12.) There was thus included in the respondent's taxable income for 1923 the entire sum of $137,521.30, representing the difference between the price at which the bonds were issued and the price at which the same bonds were repurchased by the taxpayer in 1923. (Finding 6, R. 12.) A tax of $17,188.99 was imposed on this item.

A claim for refund of $17,188.99 was duly filed on the ground that the sum of $137,521.30 was not taxable gain to the Kirby Lumber Company. (Finding 8, R. 12.) This claim was rejected (Finding 9, R. 12) and thereupon the respondent

brought suit in the Court of Claims. That court held that the respondent was entitled to recover the sum of $17,188.99, with interest. (R. 12, 13.)

SPECIFICATION OF ERRORS

1. The Court of Claims erred in holding that the gain resulting from the sale and retirement of the respondent's bonds was not taxable as income.

2. The Court of Claims erred in giving judgment for the respondent.

SUMMARY OF ARGUMENT

I

The retirement of the bonds at less than the issuing price produced income for the respondent. The whole transaction in 1923, so far as the retired bonds are concerned, increased the respondent's assets by $137,521.30. We submit that this was income within the meaning of the Revenue Act.

This financing strengthened the respondent's fiscal position. It had $137,521.30 where it had nothing before. The transaction caused an increase during the taxable year 1923 in the respondent's net worth. Clearly this was a transaction which resulted in a profit since within the taxable year and by virtue of the issue of its bonds at par and their repurchase at a discount the taxpayer received property worth $137,521.30 more than it paid for it.

The gain realized from this transaction is similar to that obtained by skillful or fortunate manipulation of corporate securities in "short selling." Income from this source has been uniformly taxed under the various Revenue Acts since the adoption of the Sixteenth Amendment. The taxability of such income has never been questioned. We submit that the transaction in the present case, similar in many respects, gave rise to income to the respondent.

II

The statute is comprehensive and the regulations expressly provide that this income is taxable. Section 213 of the Revenue Act of 1921 includes in gross income "gains or profits and income derived from any source whatever." We submit that the gain which the respondent received is taxable under the plain and comprehensive language of the statute. But the Government's position does not depend alone upon the general language of the statute. Article 45 of Regulations 62 specifically provides that the gain derived from a transaction such as the one here in question shall be included as taxable income.

This regulation has been in force without change for over twelve years. During this period Congress has four times reenacted the statute on which it is based. This reenactment in the face of consistent administrative construction amounts to a

legislative recognition and approval of the statute as so construed. We submit that this fact alone is sufficient to require the decision of the present issue in favor of the United States.

III

The authorities tend to support the Government's position. The only court decision dealing directly with this question is that of the Court of Claims in the instant case. But the reasoning and dicta of other analogous decisions lend support to the Government's view that a taxable gain was realized.

The Court of Claims held that there was a gain to the taxpayer in the transaction under consideration, but that the question of the taxability of this gain was concluded against the Government by the decision of this Court in *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170. But this case differs materially from the *Kerbaugh-Empire* case: Here by the repurchase of the bonds at a discount during the taxable year in which they were issued a gain resulted from the entire transaction, whereas in the *Kerbaugh-Empire* case the transaction extending over several years resulted in a loss which was merely reduced by exchange transactions within the taxable year.

The bonds of the Kirby Lumber Company were retired for cash. The cost of retiring them was $137,521.30 less than the value received by the com-

pany upon their issuance. This sum became "free assets" of the company and, we submit, was taxable income to it.

ARGUMENT

I

THE RETIREMENT OF THE BONDS AT LESS THAN THE ISSUING PRICE PRODUCED INCOME FOR THE RESPONDENT

In July, 1923, the respondent issued bonds secured by a mortgage on various of its properties of the par value of $12,126,800. This bond issue increased the respondent's assets and liabilities in equal amounts, for the Court of Claims found that the respondent received "the par value of the bonds issued." (R. 12.) Later in the same year the respondent retired some of these same bonds at less than par. Bonds of the par value of $1,078,300 were purchased by the respondent for $940,778.70 and canceled. This retirement decreased the respondent's liabilities by $1,078,300 with a corresponding decrease of its assets of only $940,778.70. The whole transaction in 1923, so far as the retired bonds are concerned, increased the respondent's assets by $137,521.30. We submit that this was income within the meaning of the Revenue Act.

This financing strengthened the respondent's fiscal position. It had $137,521.30 where it had nothing before. One of the results of the retirement was to reduce the amount of the mortgage lien

that was security for the bonds. By the purchase at less than par value of the retired bonds the respondent actually received and enjoyed a net gain of the amount of the discount. The obligation of the bonds for which it received par value was liquidated by the return of less than the amount received. The transaction caused an increase during the taxable year 1923 in the respondent's net worth.

Income connotes the receipt of some tangible profit, a gain separated from the transaction which gave rise to it. The word is not used in the Revenue Acts with any intent to exclude the result of good fortune and the skill with which corporate officers in borrowing money take advantage of economic and financial conditions. Income may be realized from the gain resulting from fluctuations of corporate securities as well as from manual labor.

It is an apparent and reasonable conclusion that the respondent received a *gain* by issuing and retiring these bonds. The contract between the respondent and its bondholders was the result of negotiations involving the taxpayer's labor, business acumen, and judgment, as well as the use of its capital. The gain, that is, the increase in the company's net worth, was derived from labor or capital or both combined. The net worth of the corporation was increased as the result of the completed transaction, not because it was bound to do so by an existing obligation, but because it was advantageous to the corporation so to do. This new

and independent transaction of the retirement of the bonds was accomplished for the purpose of making a profit by the prepayment of a debt—for the purpose of realizing a gain which was the outgrowth, not of an increment in the value of property previously acquired but of changed economic conditions, which made the company's promise to pay now less valuable to the obligee although it was equally onerous on the obligor. Clearly this was a transaction which resulted in a profit since within the taxable year and by virtue of the issue of its bonds at par and their repurchase at a discount the taxpayer received property worth $137,521.30 more than it paid for it.

The gain realized by the respondent from this transaction is similar to that realized by skillful or fortunate manipulation of corporate securities in "short selling." Income from this source has been uniformly taxed under the various Revenue Acts since the adoption of the Sixteenth Amendment. The "borrower" in short selling, like the respondent in the instant case, increases his liabilities and by skillful or fortunate handling of the sums so obtained makes a clear profit when later he pays off his obligations and liquidates these newly acquired liabilities.

In the instant case the respondent's contractual obligation was to meet the newly issued bonds. By retiring them it liquidated that liability for less than it had received on assuming it and so realized a clear gain. That taxable income is received in

the case of a short sale upon the close of the transaction has been settled for years (see 1 Cumulative Bulletin (April–December, 1919) p. 60), and has never been seriously questioned. We submit that the transaction in the instant case, similar in many respects, gave rise to income to the respondent.

II

THE STATUTE IS COMPREHENSIVE, AND THE REGULATIONS EXPRESSLY PROVIDE THAT THIS INCOME IS TAXABLE

The Revenue Act of 1921 imposed an income tax upon the "net income of every corporation" and defined "net income" as being gross income less certain deductions not material in this case.

Section 213 of that Act defined gross income as follows:

> That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.

The statute thus plainly makes taxable "gains or profits and income derived from any source whatever." It is clear that the respondent did derive a gain from the transaction now under consideration, and we submit that this gain is taxable under the plain and comprehensive language of the statute. But the Government's position does not depend alone upon the general language of the statute. By Section 1303 of the Revenue Act of 1921, authority was expressly granted to the Commissioner of Internal Revenue to issue regulations with the approval of the Secretary of the Treasury. In accordance with this authority, Regulations 62 were duly promulgated on February 15, 1922. Section 1 of Article 545 of these regulations reads as follows:

> ART. 545. *Sale and retirement of corporate bonds.* (1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face

value over the purchase price is gain or income for the taxable year.[2]

This regulation under the 1921 Act is in identically the same language as that of Article 544 of Regulations 45, promulgated April 17, 1919, under the provisions of the Revenue Act of 1918. This article incorporated the previous practice, although the earlier regulations did not deal fully with the question.[3] And the same regulation has continued without change under each of the revenue acts enacted since 1921. Article 545 of Regulations 65, promulgated October 6, 1924, under the Revenue Act of 1924; Article 545 of Regulations 69, promulgated August 28, 1926, under the Revenue Act of 1926; Article 68 of Regulations 74, promulgated February 15, 1929, under the Revenue Act of 1928.

It consequently appears that for at least twelve years there has been a formal regulation specifically requiring that the gain from such a transaction as that now in question shall be included in gross income. This regulation deals with the matter specifically and reasonably. It is of long standing and has been consistently applied. The regulation is in accord with common understanding and busi-

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[2] Sections 2 and 3 of Article 545 (set out in full in Appendix A, *infra*, pp. 20–22) deal comprehensively with the issuance of bonds at a premium or at a discount and their later repurchase at either a gain or loss.

[3] See Article 135 of Regulations 33, promulgated January 5, 1914, under the Revenue Act of 1913, and Article 150, par. 464, of Regulations 33 (revised), promulgated January 2, 1918, under the Revenue Act of 1916.

ness practice.[4] Such a regulation should not be overturned unless it is clearly contrary to law.

Since this regulation was first promulgated in its present form Congress has four times reenacted the statute on which it is based. The reenactment of this statute in 1921, 1924, 1926, and 1928, in the face of the consistent administrative construction amounts to a legislative recognition and approval of the statute as so construed. *National Lead Co.* v. *United States*, 252 U. S. 140; *Brewster* v. *Gage*, 280 U. S. 327, 336; *Universal Battery Co.* v. *United States*, 281 U. S. 580; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375, 378; *McCaughn* v. *Hershey Chocolate Co.*, 283 U. S. 488.

We submit that this fact alone is sufficient to require the decision of the present issue in favor of the United States.

III

THE AUTHORITIES TEND TO SUPPORT THE GOVERNMENT'S POSITION

The only court decision dealing directly with this question is that of the Court of Claims in the instant case. The reasoning and dicta in certain analogous cases lend support to the Government's view that a taxable gain was realized.

In *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 351–352, it was said, although not necessary to the decision, that if certain reserves set aside in 1912 were excessive and were released to

[4] Excerpts from authorities on accounting are quoted in Appendix B, *infra*, pp. 23–24.

the general use of the company and increased its free assets in 1913 then the amount of such excess released to the general uses of the company should be treated as income in the year 1913, and taxed accordingly. This Court said:

> Reserves, as we have seen, are funds set apart as a liability in the accounts of a company to provide for the payment or reinsurance of specific contingent liabilities. * * * The amount "reserved" in any given year may be greater than is necessary for the required purposes, * * *. If, in this case, it were due to an overestimate of reserves for 1912 with a resulting excessive deduction for that year from gross income and if such excess was released to the general uses of the company and increased its free assets in 1913, to that extent it should very properly be treated as income in the year in which it became so available, for the reason that in that year, for the first time, it became free income, under the system for determining net income provided by the statute, and the fact that it came into the possession of the company in an earlier year in which it could be used only in a special manner, which permitted it to become nontaxable would not prevent its being considered as received in 1913 for the purposes of taxation, within the meaning of the act.

In *Commissioner* v. *Simmons Gin Co.*, 43 F. (2d) 327 (C. C. A. 10th), it was held that cancellation by creditors of indebtedness of an *insolvent*

corporation was not taxable income to the debtor corporation. The court intimated that had the corporation been solvent so that the release of the liability would have set free assets, the transaction might have resulted in a taxable gain.

In *Charleston & W. C. Ry. Co.* v. *Burnet*, 50 F. (2d) 342 (App. D. C.), it was held that unpaid wages, carried in a suspense account awaiting demand of the employee, are to be treated as income in the year in which they are charged to profit and loss on the assumption that they will never be claimed. The same point was similarly decided in *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7th). It was also held in this latter case that where outstanding bonds are retired by an issuance of stock, in the absence of a showing that the stock was worth more than the bonds there is no deductible loss. The court in discussing the problem recognized that if the bonds, which had been issued below par, had been retired at par a loss would have been realized, and conversely that had the bonds been bought in at less than the issuing price a taxable gain would have resulted.

The Court of Claims, in its decision in the present case, held that there was a gain to the taxpayer in the transaction under consideration, but that the question of the taxability of that gain was concluded against the Government by the decision of

this Court in *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170.[5] It said (R. 15):

> We think the decision in the Kerbaugh-Empire case fully sustains the contentions of plaintiff in the instant case that the excess of the issuing price of its bonds over the purchasing price of such of its bonds as it purchased subsequent to issue, is not taxable as income, and that the taxes herein were erroneously assessed and collected.

Since that view of the *Kerbaugh-Empire* case was expressed there has been an authoritative definition of its holding. In the case of *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, this Court said (p. 364):

> In that case [*Bowers* v. *Kerbaugh-Empire Co.*] the taxpayer, which had lost, in business, borrowed money, which was to be repaid in German marks, and which was later repaid in depreciated currency, had neither made a profit on the transaction, nor received

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[5] The Board of Tax Appeals in a number of cases has reached the same conclusion by the same process of reasoning. See *Appeal of Independent Brewing Company*, 4 B. T. A. 870; *Appeal of New Orleans, Texas and Mexico Ry Co.*, 6 B. T. A. 436; *Houston Belt & Terminal Railway Company* v. *Commissioner*, 6 B. T. A. 1364; *Indianapolis Street Railway Company* v. *Commissioner*, 7 B. T. A. 397; *National Sugar Manufacturing Co.* v. *Commissioner*, 7 B. T. A. 577, note dissenting opinion; *Petaluma & Santa Rosa Railroad Co.* v. *Commissioner*, 11 B. T. A. 541; *General Manifold & Printing Co.* v. *Commissioner*, 12 B. T. A. 436; *Douglas County Light & Water Co.* v. *Commissioner*, 14 B. T. A. 1052, reversed on another issue, 43 F. (2d) 904 (C. C. A., 9th); *John F. Campbell Co.* v. *Commissioner*, 15 B. T. A. 458, affirmed on another issue (App. D. C.), May 4, 1931.

> any money or property which could have been made subject to the tax.

That the Court of Claims in its decision in the instant case did not so understand the *Kerbaugh-Empire* case seems indicated by its statement that (R. 15)—

> In our opinion the question whether the person engaging in such transaction is solvent or insolvent, or whether he made a profit or suffered a loss through the use of the money for which the obligations were issued is wholly immaterial.

The Government urges that the fact that the Kirby Lumber Company made a gain where the Kerbaugh-Empire Company suffered a loss, is highly material.

In addition to the presence here of an express Treasury regulation fully covering the situation, which was not present in the *Kerbaugh-Empire* case, the case at bar differs from that case in this outstanding feature:

Here by the repurchase of the bonds at a discount during the taxable year in which they were issued a gain resulted from the entire transaction, whereas in the *Kerbaugh-Empire* case the transaction, extending over several years, resulted in a loss which was merely reduced by exchange transactions within the taxable year.

The importance of these differences appears when it is considered that in the *Kerbaugh-Empire* case this Court pointed out (p. 175):

> The transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital. * * * The result of the whole transaction was a loss.

There was but one transaction involved in that case: the borrowing of money prior to July 2, 1913, its loss before 1921, and its repayment according to the tenor of the original contract. This Court described that transaction as follows (p. 175):

> When the loans were made and notes given, the assets and liabilities of defendant in error were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit, or income.

In the instant case the transaction resulting in the gain taxed can not be so described. It is, of course, true that under the original undertaking, *i. e.*, the issuance of the bonds, the assets and liabilities were increased alike, so that no gain or loss then resulted. It is also true that this original undertaking contemplated that the closing of the transaction, *i. e.*, the payment of the bonds at maturity, would eliminate the increase of the assets at the time the liability was extinguished. But that contemplated result did not occur. Nor did any in-

tervening cause diminish the assets leaving the liability. Upon the repurchase of the bonds the liability was wiped out without an equivalent elimination of the earlier increase in the assets.

The bonds of the Kirby Lumber Company were retired for cash. No further capital liability of uncertain value such as a stock issue was incurred in order to cancel the bonds. The cost of retiring them was $137,521.30 less than the value received by the company upon their issuance. This sum became "free assets" of the company and, we submit, was taxable income to it.

CONCLUSION

The decision of the court below is erroneous and should be reversed.

Respectfully submitted.

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OCTOBER, 1931.

APPENDIX A

STATUTES AND REGULATIONS INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 254, provides in part:

> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 * * *.

Article 545 of Regulations 62, promulgated February 15, 1922, under the Revenue Act of 1921, provides:

> ART. 545. *Sale and retirement of corporate bonds.*—(1) (*a*) If bonds are issued by a corporation at their face value, the corpo-

ration realizes no gain or loss. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. See section 234 of the statute and article 563. (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2) (*a*) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year.

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.

(*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year.

(*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year.

APPENDIX B

EXTRACTS FROM AUTHORS ON ACCOUNTING

I

Gilman, Principles of Accounting, 1916, at pages 209 and 210.

Thus a twenty-year $1,000 bond may contain the provision that it is redeemable or callable in ten years at 105. This means that the holder of the bond must surrender it for $1,050.00 at any time after ten years if he is called upon to do so. If, however, the corporation can buy its own bonds in the open market for less than $1,050.00, it will do so. Assuming that a reserve has been built up for the purpose of buying back bonds at 105, you will find that each purchase in the market at a less price will result in a profit which may very properly be credited to the Interest Account.

II

Dickinson, Accounting Practice & Procedure, 1918, at page 137:

The first and most correct method * * * the effective interest method, * * *. For instance, if the conditions of the issue provided that $100,000 of bonds be retired during the year at 105, and as a matter of fact they are purchased at 95, the true interest on the bonds bearing interest during the year would be reduced by $10,000, representing the

saving on bonds retired during the year as compared with the price therefor assumed in determining the effective rate.

The second and more common method, which may be called the equal installment method, is to ignore altogether the effective interest rate; to charge to income account each year the interest actually paid, together with a proportionate part, according to the whole term of issue, of the discount on issue or premium on redemption; Income account being also credited with any savings made by purchase of bonds in the market.

U. S. GOVERNMENT PRINTING OFFICE: 1931

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1930.

No. 759.

THE UNITED STATES, *Petitioner*,

vs.

KIRBY LUMBER COMPANY.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI.

QUESTION PRESENTED.

Does a corporation realize taxable income when it discharges a debt prior to maturity by payment of a lesser sum than that called for on the face of the bonds which represent the debt?

STATEMENT.

July 16, 1923, the Kirby Lumber Company made a deed of trust on certain of its property to secure the

payment of certain bonds. $12,126,800 of the said bonds were issued at par (Findings 4 and 7, R. 12). (The bonds were not issued for cash, as stated by petitioner, but were exchanged for preferred stock on the lowest permissible basis, a price of $105 per $100 share and accrued dividends of $126 per share, or a total of $231 per share.) During 1923 the Kirby Lumber Company purchased $1,078,300 par value of these bonds for $940,778.70, or $137,521.30 less than the issuing price, and retired the said bonds so purchased (Finding 5, R. 12).

REASONS WHY PETITION SHOULD BE DENIED.

The petition should be denied for the following reasons:

1. The Kirby Lumber Company did not receive "income" within the meaning of the Sixteenth Amendment.
2. The principle involved has been decided by this Court.
3. There is no conflict of decisions on the point involved. To the contrary, there is a long line of decisions sustaining the decision of the Court below.
4. The petition misstates a material fact.
5. The Government's position is not sound.

ARGUMENT.

The transaction here involved is nothing more nor less than the payment of a debt. Any effort to make more out of the case merely tends to confuse the issue and is not supported by the facts.

Only "Income" Can be Taxed.

The Sixteenth Amendment grants power to Congress to "lay and collect taxes on incomes, from whatever source derived."

The question in this case, therefore, is whether the item on which the taxpayer was taxed is "income," "from whatever source derived" under the Amendment. Unless it is "income," then, as a direct tax on personal property, without apportionment, its imposition on the taxpayer in this case would be beyond the powers of Congress as established by *Pollock v. Farmers' Loan and Trust Co.*, 157 U. S. 429.

"Income" has been repeatedly defined by this Court as:

1. Gain derived from capital;
2. Gain derived from labor;
3. Gain derived from capital and labor combined;
4. Profit gained through a sale or conversion of capital assets.

The Court in explaining this definition states:

> "* * * Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived'*, that is *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description." *Eisner v. Macomber*, 252 U. S. 189, 207.

It is difficult to make a better argument in the case at bar than to quote from the District Court opinion

in *Kerbaugh-Empire Co. v. Bowers,* 300 Fed. 938. At page 943 the Court states:

> "* * * Nothing has been severed from the plaintiff's capital as a result of this transaction which has come into the plaintiff. The improvement of the plaintiff's balance sheet is not income to the plaintiff. All that it had was a decrease in liability. * * *"

At page 945 the Court continues:

> "* * *. It seems clear that neither the Sixteenth Amendment nor the Revenue Act sought to levy an income tax upon anything except income as it was actually received, and under the Constitution and the Revenue Act of 1921 there can be no such thing as a negative income; the two words being inconsistent."

The very most which can be said of the transaction here involved is that the capital structure of the plaintiff was improved.

> "* * * enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Eisner v. Macomber,* 252 U. S. 189, 214.

A somewhat similar situation to the one here presented is where debts of a taxpayer are, for one reason or another, cancelled. The earliest of these decisions is *U. S. vs. Oregon-Washington R. & Nav. Co.,* 251 Fed. 211, where the Court (C. C. A. 2nd) held adversely to the Government's contention stating (p. 212):

> "However, the tax, though it includes income 'from all sources,' nevertheless includes 'income' only, and the meaning of that word is not to be

found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction, it seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital; *i. e.*, wealth industrially employed in permanent form. It includes the earnings from a calling, as well as interest, royalties, or dividends, though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed.

"Now, it seems to us hardly arguable that the cancellation of the debt in question was not in the category of capital. * * *"

This Court expressed the same thought in *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185:

"* * * Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. * * *"

The Board of Tax Appeals, in many cases, has held that the cancellation of indebtedness does not result in taxable income. A few cases are:

Meyer Jewelry Co., 3 B. T. A. 1319;
John F. Campbell, Co., 15 B. T. A. 458;
Eastside Mfg. Co., 18 B. T. A. 461;
Progress Paper Co., 20 B. T. A. 234.

"The cancellation of the indebtedness, therefore, constituted a gift to the corporation or a contribution to its capital * * *." *R. E. Olds*, 18 B. T. A. 1215; 1220.

Principle Has Been Decided by This Court.

As the Court of Claims states (R. 14) the principle involved has been decided by this Court. In *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, 173, it is stated:

"The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the Custodian and the value when the loans were made was income."

In other words, the question in the Kerbaugh-Empire case was precisely the same as the question here presented—Does a corporation realize taxable income by paying a debt for a lesser sum in dollars than it was originally obligated to pay?

The petition in this case attempts to show that the Kerbaugh-Empire case decided an issue different from the issue stated by the Court and as quoted above. When the case was presented to the Court, however, the Government clearly stated the issue as follows:

"The question in this case is whether or not the profit or gain made by a corporation as the result of borrowing foreign money and later settling its debt at a rate of exchange lower than

that at which the loan was made is taxable income." Page 1, Government's brief in *Bowers v. Kerbaugh-Empire Co.*, No. 173, October Term, 1925.

In the Kerbaugh-Empire case the Government had a strong equity not here present, because the taxpayer had been permitted to deduct from prior years' income losses totalling $1,983,000 and yet the taxpayer was only out of pocket in the principal amount of $80,411.12 when the obligation was paid in 1921.

The Kirby Lumber Company did not have any deductible loss in 1923 or any other year as a result of the transaction. Instead, for each and every year after the $1,078,300 debt was paid, the payment of interest thereon ceased ($64,698 per annum), and the deductions from income in the tax return on account of interest payments were reduced in a like amount, resulting in additional tax payment.

There is no Conflict of Decisions on the Point Involved.

On the point here involved the Board of Tax Appeals has held in favor of the taxpayer. The following are examples:

Independent Brewing Co., 4 B. T. A. 870;
New Orleans, Texas & Mexico Ry. Co., 6 B. T. A. 436;
Houston Belt & Terminal Ry. Co., 6 B. T. A. 1364;
National Sugar Mfg. Co., 7 B. T. A. 577;
Petaluma & Santa Rosa R. R. Co., 11 B. T. A. 541;
General Manifold & Printing Co., 12 B. T. A. 436;

Chicago, Rock Island & Pacific Ry. Co., 13 B. T. A. 988;
American Seating Co., 14 B. T. A. 328;
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Houghton & Dutton Building Trust, 20 B. T. A. 591;
American Tobacco Co., 20 B. T. A. 586;
Boulevard Building Co., 21 B. T. A. 864;
Norfolk Southern R. R. Co., decided Feb. 20, 1931;
Coastwise Transportation Co., decided Feb. 25, 1931.

The first of the decisions on the point was decided by the Board of Tax Appeals September 18, 1926. The Revenue Act of 1926, which became effective February 26, 1926, provided for appeal from the Board of Tax Appeals to the Circuit Courts of Appeal. Despite the many decisions cited above, the first appeal was filed December 19, 1930, when *Kirby Lumber Co.*, 19 B. T. A. 1046, was taken to the Fifth Circuit. February 4, 1931, the case of the *American Tobacco Co.*, 20 B. T. A. 586, was appealed to the Second Circuit.

The Government admits that it has "found no conflict of decisions upon the question here involved" (R. 5). If this Court is not going to be overwhelmed by being asked to decide nearly all issues which arise in the administration of the taxing laws it would seem that certiorari should not issue except to afford a uniform application of the law where a conflict of decisions exists.

The Petition Misstates a Material Fact Which is Misleading.

In the first paragraph of the Statement in the petition (R. 2) it is stated:

> "* * * For these bonds the Lumber Company received cash at par for each bond."

On page 4 of the Record, where an effort is made to bring this case within the language of *Burnet, Commissioner, v. Sanford & Brooks Co.*, 282 U. S. 359, the petition states:

> "In the instant case there is both (1) a clear gain or profit and (2) actual cash received during the year in excess of disbursements made or incurred."

Counsel fully realizes that the Government would not intentionally mislead this Court for the purpose of securing the writ which is sought. However, a most serious distortion of facts is presented in the foregoing quotations because the Kirby Lumber Company DID NOT RECEIVE CASH for the bonds here involved. The bonds were issued at par, as found by the Court of Claims (Finding 7, R. 12), but they were exchanged for preferred stock on the lowest permissible basis, a price of $105 per $100 share plus accrued dividends of $126 per share, or a total of $231 per share.

The bond issue simply resulted in a change in the capital structure of the corporation. Prior to the bond issue the balance sheet showed preferred stock as a liability, while after the bond issue the bonds were shown as the liability. There was no gain or profit, and no cash was received.

Government's Position is Unsound.

To illustrate the unsoundness of petitioner's contention suppose the A Corporation purchased a factory for $150,000 of which amount it paid $50,000 with cash in its possession, and $100,000 with money obtained from B and secured by a mortgage on the factory. Before maturity B became in need of funds and accepted $90,000 in full payment of the mortgage. Under the Government's theory the A Corporation would make a taxable gain of $10,000, despite the fact that the transaction resulted in a total outlay by the A Corporation of $140,000. The next step in this theory is that if the A Corporation sold its factory for $140,000 in cash it would lose $10,000. Such reasoning is obviously not the law.

In *Des Moines Improvement Co.*, 7 B. T. A. 279, the taxpayer executed second mortgages totalling $45,000. The holder of the mortgages cancelled them upon receiving $33,200 in cash. The Board held the $11,800 difference between the face value of the mortgages and the sum necessary to retire them was not income. The Commissioner of Internal Revenue acquiesced in this decision (C. B. June 1929, p. 12).

The Government's position in this case is somewhat confused, but apparently it is that income was realized when the bonds here involved were "purchased." As stated, the transaction, in reality, was the payment of a debt. It is obvious, of course, that income cannot be realized by the purchase of anything. When income is made as the result of a capital transaction it is by "the sale or other disposition" of a capital asset. It is significant that the petitioner has not cited a single case where taxable profit is realized

by purchase. If income could be realized by purchase every "good bargain" would be taxable to the purchaser when the purchase was made, and the labyrinth of tax law would, indeed, become endless.

Importance of Point Involved.

No attempt will be made to answer the argument that the writ should issue because cases on the point pending in the Bureau of Internal Revenue involve $10,000,000. Unquestionably the Court will decide the case on the law of the point involved.

CONCLUSION.

The decision of the Court below is correct. There is no conflict of decisions. It is respectfully submitted that the petition should be denied.

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April, 1931.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 26.

THE UNITED STATES, *Petitioner*,

v.

KIRBY LUMBER COMPANY.

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

BRIEF FOR RESPONDENT.

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IN THE

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THE UNITED STATES, *Petitioner*,

v.

KIRBY LUMBER COMPANY.

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

BRIEF FOR RESPONDENT.

QUESTION PRESENTED.

Does a corporation realize taxable income when it discharges a debt prior to maturity by payment of a lesser sum than that called for on the face of the bonds which represent the debt?

STATEMENT.

In June, 1923, the Kirby Lumber Company issued bonds secured by a deed of trust on certain of its property. During 1923 the Kirby Lumber Company purchased $1,078,300 face value of the said bonds for $940,778.70, or $137,521.30 less than the face value of the bonds purchased, and retired them. The question is whether the said $137,521.30 is taxable income to the Kirby Lumber Company.

The Kirby Lumber Company contends that the consideration received for the bonds is immaterial. The transaction here sought to be taxed is the purchase of certain of the bonds and their retirement. If, however, the Court believes the consideration is material the motion to remand to the Court of Claims which was submitted May 25, 1931, should be granted.

In the Court of Claims the facts were stipulated, and the stipulation adopted by the Court as its findings of fact. The record does not show the consideration for which the bonds were issued.

If remanded the proof will show that in 1923 the Kirby Lumber Company had $5,000,000 par value preferred stock outstanding, callable at $105 per share, on which there were accrued dividends of $126 per share, or a total capital liability of $231 per share. $11,526,800 in bonds, plus $9,776.94 in cash, were exchanged for the preferred stock at the price of $231 per share, computed as indicated above. In July, 1925, $600,000 additional of bonds were issued, but that $600,000 of bonds are not in issue here. In other words, the issuance of the bonds in 1923 merely changed the nature of the lumber company's liability to its preferred stockholders from stockholders to

bondholders. No money came into the company, in fact, $9,776.94 was paid out, and the assets were not increased. In addition the proof will show the past history of the Kirby Lumber Company, its inability to pay interest on its preferred stock for many years prior to 1923, and other facts to indicate that the price at which the Kirby Lumber Company purchased its bonds in 1923 was not more than the value of the Company's promise to pay the said bonds fifteen years thereafter.

Counsel feels justified in calling the above-mentioned facts to the attention of the Court because the Government, in its brief, has drawn conclusions from the Court of Claims findings of fact which are not justified by the record. The Court of Claims did not find that the Kirby Lumber Company "sold" the bonds or that the Company's assets were increased by the bond issue.

SUMMARY OF ARGUMENT.

I.

It is established that "income" under the Sixteenth Amendment is the gain derived from capital, the gain derived from labor, the gain derived from capital and labor combined, the profit gained through a sale or conversion of capital assets. This case does not meet the definition as no income was derived from the transaction. The transaction was the expenditure, rather than the receipt of money. Such could not be income.

II.

The principle involved has been decided by this Court in *Bowers v. Kerbaugh-Empire Co.*, 271 U. S.

170, wherein it was held that a corporation does not realize taxable income by settling a debt for a lesser sum in dollars than it was obligated to pay.

III.

The Board of Tax Appeals in a long line of cases beginning with *Independent Brewing Co.*, 4 B. T. A. 870, decided September 18, 1926, has held that no income is realized in the circumstanees here involved.

IV.

It is thoroughly established by a long line of cases that cancellation of indebtedness is a capital transaction which does not result in income. These cases involve the same principle as the case at bar.

V.

Income has been determined by this Court to mean the gain or income arising from corporate activities. It does not mean transactions not connected with the corporate activities and which only affect the capital structure of the corporate taxpayer.

VI.

Another way of looking at the transaction is that it is a purchase by the taxpayer of its promise to pay. It is settled that income can be realized only by the sale or other disposition of capital assets. If income can be realized by purchase it will mean that every "good bargain" is taxable when made. If purchase can result in income it did not in this case because bonds were purchased at their then value, as shown by the judgment of the market place.

VII.

Government's position is unsound.

VIII.

The authorities cited in the Government's brief do not support its position.

ARGUMENT.

I.

Only Income Can Be Taxed.

The Sixteenth Amendment grants power to Congress to "lay and collect taxes on incomes, from whatever source derived."

The question, therefore, is whether the transaction on which this taxpayer was taxed is "income" under the Amendment. Unless it is "income", then, as a direct tax on personal property, without apportionment, its imposition on this taxpayer would be beyond the powers of Congress as established by *Pollock v. Farmers Loan and Trust Co.*, 157 U. S. 429.

"Income" has been repeatedly defined by this Court as:

1. Gain derived from capital.
2. Gain derived from labor.
3. Gain derived from capital and labor combined.
4. Profit gained through a sale or conversion of capital assets.

The Court, in explaining this definition, states:

> "* * * Here we have the essential matter; *not* a gain *accruing* to capital, not a *growth* or *incre-*

ment of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived,'* that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description." (*Eisner v. Macomber*, 252 U. S. 189, 207.)

The District Court in *Kerbaugh-Empire Co. v. Bowers*, 300 Fed. 938, in applying Eisner v. Macomber to the case then being considered, uses language that aptly argues the case at bar. At page 943 the Court states:

"• • • Nothing has been severed from the plaintiff's capital as a result of this transaction which has come into the plaintiff. The improvement of the plaintiff's balance sheet is not income to the plaintiff. All that it had was a decrease in liability. In Eisner v. Macomber, *supra*, it was held that 'enrichment through increase in value of capital investment is not income in any proper meaning of the term.'"

At page 944 the Court continues:

"• • • As a matter of fact there was not even an increase of assets. There was a decrease of assets through the payment of a part of plaintiff's assets in settling the indebtedness. The fact that after the transaction the plaintiff's balance sheet had improved was not sufficient to constitute 'a gain derived from capital.' If anything, it was a gain accruing to capital, and, as such, under the Eisner and Phellis Cases, was not taxable income."

In the case at bar the real transaction was that the Kirby Lumber Company parted with $940,778.70 in cash. In return therefor it secured certain of its promises to pay as evidenced by bonds and cancelled the said promises. The balance sheet was improved, but the improvement of the balance sheet did not separate something from the property which the taxpayer got for its separate use, benefit and disposal. In other words, the net result was that the Kirby Lumber Company reduced its cash $940,778.70 and had nothing to offset it but book entries in its capital account. It realized no "income."

II.

Principle Has Been Settled by This Court.

In 1926 this Court decided that a corporation realized no income by settling a debt for a lesser sum in dollars than it was obligated to pay.

In *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, the Kerbaugh Company, before the war, borrowed money in Germany repayable in marks or their equivalent in gold coin of the United States. A subsidiary of the Kerbaugh-Empire Company, for whose use the money was borrowed, lost the money in business and claimed, and was allowed, a loss of such amounts in its income-tax return for the years in which the losses occurred.

In 1921 the Kerbaugh-Empire Company made payment of the balance due on its notes. Owing to the depreciated value, at that time, of the German mark there was, measured by United States gold coin, a difference between the value of the marks borrowed at the time the loans were made and the amount paid

in liquidation of the unpaid balance the sum of $684,456.18. The Commissioner of Internal Revenue treated this sum of $684,456.18 as income for the year 1921 and assessed taxes thereon. This Court held that it was not taxable income. The Court states the issue to be (page 173):

> "The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the custodian and the value when the loans were made was income."

On page 1 of the Government's brief in the Kerbaugh-Empire case (No. 173, October Term, 1925) it is stated:

> "The question in this case is whether or not the profit or gain made by a corporation as the result of borrowing foreign money and later settling its debt at a rate of exchange lower than that at which the loan was made is taxable income."

At page 16 of the Government's brief in the Kerbaugh-Empire case it is argued:

> "Another and equally logical way of viewing the transaction is to liken it to the purchase and retirement by a corporation of its own bonds at a price less than the issuing price. That such sales and retirement of corporate bonds result in income must be taken as settled."

The brief then cites Article 545 of Regulations 65 to sustain the contention that the purchase and retire-

ment of corporate bonds results in income. No decisions are cited.

At pages 17 and 18 of the Government's brief in the Kerbaugh-Empire case it is stated:

> "So in the instant case, the reality of the transaction is that defendant in error sold its promise to pay a certain number of marks for $764,867.30 and later bought this promise back for $80,411.12. The fact that this promise was in the shape of a promissory note instead of a corporate bond did not affect the essential character of the transaction. Nor does the fact that the note itself was never actually returned to defendant in error make any material difference. So far as the practical result is concerned the receipt which the defendant in error received from the Alien Property Custodian is as effective as though the note itself had been returned and cancelled. In the present case, if the corporation had borrowed $764,867.30 through the sale of bonds which it later retired for $80,411.12, no one would doubt for a moment that under the Treasury Regulations above referred to the difference between these sums would have been taxable as a part of its income. What was actually done was that the corporation borrowed $764,867.30 through the sale of its note and retired that obligation for $80,411.12. Is there any conceivable difference in principle between the case supposed and that now under consideration? The analogy is perfect."

It seems, therefore, that while the Government now contends that the Kerbaugh-Empire case is not controlling on the case at bar it argued directly to the contrary when the Kerbaugh-Empire case was before the Court.

In other words, the question in the Kerbaugh-Em-

pire case was precisely the same as the question here presented. Does a corporation realize taxable income by settling a debt for a lesser sum in dollars than it was obligated to pay? Unless this Court specifically over-rules the Kerbaugh-Empire case decision must be for the Kirby Lumber Company in the case at bar.

In the Kerbaugh-Empire case the Government had a strong equity not here present, because the taxpayer's subsidiary had been permitted to deduct losses totalling $1,983,000 from prior years' income, and yet the taxpayer was out of pocket in the principal amount of only $80,411.12 when the obligation was paid in 1921.

That the Court correctly decided the Kerbaugh-Empire case is quite apparent. In disposing of the case the Court states (page 174):

> "* * * 'Income' has been taken to mean the same thing as used in the Corporation Excise Tax Act of 1909, in the Sixteenth Amendment and in the various revenue acts subsequently passed. *Southern Pacific Co. v. Lowe,* 247 U. S. 330, 335; *Merchants L. & T. Co. v. Smietanka,* 255 U. S. 509, 519. After full consideration, this Court declared that income may be defined as gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital. *Stratton's Independence v. Howbert,* 231 U. S. 399, 415; *Doyle v. Mitchell Brothers Co.,* 247 U. S. 179, 185; *Eisner v. Macomber,* 252 U. S. 189, 207. And that definition has been adhered to and applied repeatedly. See e. g. *Merchants L. & T. Co. v. Smietanka, supra,* 518; *Goodrich v. Edwards,* 255 U. S. 527, 535; *United States v. Phellis,* 257 U. S. 156, 169; *Miles v. Safe Deposit Co.,* 259 U.

S. 247, 252-253; *United States v. Supplee-Biddle Co.*, 265 U. S. 189, 194; *Irwin v. Gavit*, 268 U. S. 161, 167; *Edwards v. Cuba Railroad*, 268 U. S. 628, 633. In determining what constitutes income substance rather than form is to be given controlling weight. *Eisner v. Macomber, supra*, 206.

> "The transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital. * * *"

In its brief in the case at bar the Government makes much of the mention in the Kerbaugh-Empire decision that "The result of the whole transaction was a loss" (page 18 Government's brief). It is quite apparent from the statement of "the question for decision" that the decision was not dependent upon the disposition of the money borrowed. That disposition was a separate transaction upon which the gain or loss was computed. In the Kerbaugh-Empire case the taxpayer was permitted to deduct losses in prior years far in excess of its actual loss in dollars. That fact, however, did not influence the Court because the question involved was the taxation of the transaction which settled the debt.

> "The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the Custodian and the value when the loans were made was income." (*Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, 173.)

In substance the Government's argument is that, assuming there was a gain in 1921, the losses of the

Kerbaugh-Empire Company's subsidiary for 1913, 1914, 1916, 1917 and 1919 should be offset against the assumed gain in 1921. In *Burnet v. Sanford & Brooks Co.*, 282 U. S. 259, it was definitely settled that income for tax purposes must be computed on an annual basis. Obviously the Government cannot distinguish the Kerbaugh-Empire case on the argument used. In the Sanford & Brooks case, *supra*, the company lost money from 1913 to 1916 in carrying out a Government dredging contract. In 1920 by suit it recovered from the Government the amount of its losses on the contract. The Court followed the Kerbaugh-Empire case and held the amount recovered was taxable income in 1920 even though the result of the whole transaction was not a gain. These decisions make it apparent that the only question to be decided in the case at bar is whether the Kirby Lumber Company realized taxable income by the purchase and retirement of its bonds. Any question with reference to the issuance of the bonds or the consideration received therefor is a separate and distinct transaction upon which gain or loss is computed and which should not be considered by this Court.

That the purchase and retirement of the bonds must be considered as separate and distinct from their issuance is further shown by the complications which will follow if such a course is not adopted. The taxpayer at bar purchased certain of the bonds of the issue here involved at less than the face value and retired them during 1924, 1925 and 1926. (See *Kirby Lumber Co.*, 19 B. T. A. 1046, now pending before the Circuit Court of Appeals for the Fifth Circuit.) Although the bonds were issued in 1923 it seems obvious that the case for subsequent years should be

disposed of on the same basis as 1923, which is before this Court in the case at bar.

III.

The Board of Tax Appeals Has Held that no Taxable Income Results in the Situation Here Involved.

The Board of Tax Appeals, which is composed of sixteen experts in tax law, has many times decided the question here involved in favor of the taxpayer. Among the cases are:

Independent Brewing Co., 4 B. T. A. 870;
New Orleans, Texas & Mexico Ry. Co., 6 B. T. A 436;
Houston Belt & Terminal Ry. Co., 6 B. T. A. 1364;
National Sugar Mfg. Co., 7 B. T. A. 577;
Petaluma & Santa Rosa R. R. Co., 11 B. T. A. 541;
General Manifold & Printing Co., 12 B. T. A. 436;
Douglas County Light & Water Co., 14 B. T. A. 1052;
Eastern Steamship Lines, Inc., 17 B. T. A. 787;
North American Mortgage Co., 18 B. T. A. 418;
Kirby Lumber Co., 19 B. T. A. 1046;
American Tobacco Co., 20 B. T. A. 586;
Houghton & Dutton Building Trust, 20 B. T. A. 591;
Boulevard Building Co., 21 B. T. A. 864;
Norfolk Southern R. R. Co., 22 B. T. A. 302;
Coastwise Transportation Co., 22 B. T. A. 373;
Rail Joint Co., 22 B. T. A. 1277;
New York, Chicago & St. Louis R. R. Co., 23 B. T. A. 177;
Terre Haute, Indianapolis and Eastern Traction Co., 24 B. T. A.—; decided September 29, 1931.

The Revenue Act of 1926 providing for appeals to Circuit Courts of Appeal from the Board of Tax Appeals became law February 26, 1926. Despite this the first appeal on this point was not taken until December 19, 1930, when Kirby Lumber Co., 19 B. T. A. 1046, was taken to the Fifth Circuit. That case involves the identical question here presented except that it is for the years 1924, 1925 and 1926, while the case at bar involves 1923.

IV.

Similar to Cancellation of Indebtedness Cases.

Many cases have been decided where taxpayers have had indebtedness cancelled. The earliest of these decisions is *U. S. v. Oregon-Washington R. & Nav. Co.*, 251 Fed. 211 (decided April 24, 1918), wherein the Oregon Short Line Railroad, the sole stockholder of the taxpayer, released $6,190,769.57 of the indebtedness of the taxpayer to the Short Line. The Commissioner of Internal Revenue held that the debt released was income. In denying the Commissioner's contention the Circuit Court of Appeals for the Second Circuit said (page 212):

> "However, the tax, though it includes income 'from all sources,' nevertheless includes 'income' only, and the meaning of that word is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction, it seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital; *i. e.*, wealth industrially employed in permanent

form. It includes the earnings from a calling, as well as interest, royalties, or dividends, though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed.

"Now, it seems to us hardly arguable that the cancellation of the debt in question was not in the category of capital. * * *"

The Board of Tax Appeals has many times decided that a cancellation of indebtedness does not result in taxable income. Cases are:

Meyer Jewelry Co., 3 B. T. A. 1319;
John F. Campbell Co., 15 B. T. A. 458; 50 Fed. (2d) 467.
Eastside Mfg. Co., 18 B. T. A. 461;
Progress Paper Co., 20 B. T. A. 234;
Herman Sonner, 22 B. T. A. 655.

Many of the cancellation of debt cases cite the Kerbaugh-Empire case, so if the rule of that case is not followed in the case at bar great confusion and much hardship will result in cases where cancellation of indebtedness is necessary. It will mean, in fact, that the United States will be a preferred creditor, thereby reducing payments to other creditors. Such a situation would, in many instances, eliminate the possibility of composition with creditors with the

resulting destruction of enterprises which otherwise might continue to operate. Such a rule would be, to say the least, economically unsound.

At pages 15 and 17 of the Government's brief in the case at bar it is intimated that the rule should be different in cases of solvent taxpayers as compared with insolvent taxpayers. The Court of Claims rejected this contention (R. 15). Had it held otherwise a poor taxpayer would have been given a preference over a richer taxpayer who was identically situated. In determining if income is realized the nature of the transaction involved and not the solvency of the taxpayer controls.

V.

Taxable Corporate Income is the Gain or Increase Arising from Corporate Activities.

The decisions show that the income sought to be taxed was that gain or increase arising from corporate activities. The principle is expressed in *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185:

> "• • • Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities • • •."

In the case at bar the corporate activities of the Kirby Lumber Company were the manufacture and sale of lumber. The income to be taxed, as defined by this Court, was the income from those activities,

and not transactions which affected only the capital structure of the taxpayer.

VI.

Transaction in Realty is Purchase by Taxpayer of Its Promise to Pay.

One way of looking at this case is that this taxpayer has, for a valid consideration, given its promise to pay certain money in 1938.

This promise was represented by negotiable bonds of various denominations. The taxpayer saw fit to purchase a portion of its promise to pay. The query is, therefore: Did the lumber company realize taxable gain by purchasing its promises to pay? There is no instance when gain or loss is realized by the purchase of anything. It is established that gain or loss is realized only by "the sale or other disposition" of property, and not by its purchase. If this Court holds otherwise it will mean that every "good bargain" will be taxable when the purchase is made. Aside from the administrative difficulties that would follow such a ruling it is obvious that it cannot be the law because there would be no "income derived from the property" as described in Eisner v. Macomber, *supra*.

In the event the Court holds that income can be realized by the taxpayer's purchase of its promise to pay there is serious doubt whether the taxpayer realized a gain by the said purchase. Hoskold and other mathematicians have devised tables which give the theoretical present value of money due at some time in the future. In the last analysis the only real value of a promise to pay is the price at which, in the judg-

ment of the market place, the promise brings. The purchasers of such promises take into consideration the hazards of the business and other factors which make the selling price the real value. This Court will go beyond the sphere of its proper function if it attempts to say that the value of a promise to pay is something different than the price which the said promise will bring on the market. In other words, despite any theories or any face value printed on the bonds here involved the fact is that they were worth only what the taxpayer paid for them, so no taxable gain could result from their purchase.

VII.

Government's Position is Unsound.

If the Government prevails in this case it will upset established practice and cause great confusion to business and in tax administration. To illustrate:

Suppose a corporation bought a factory for $150,000, paying $50,000 in cash and assuming a mortgage for $100,000. Before maturity the holders of the mortgage became in need of funds and accepted $90,000 in full settlement of the mortgage. Under the Government's theory the corporation realized a taxable gain of $10,000, although the true fact is that the factory cost but $140,000 and not $150,000. The next step in this theory probably would be that if the corporation sold the factory for $140,000 it would lose $10,000. The foregoing is just one example of the absurd results which will follow if the Government theory is adopted.

VIII.

Comment on Authorities Cited in Brief for the United States.

Point 1.

As previously argued in this brief the transaction here sought to be taxed is the purchase and retirement of certain bonds. The issuance of the bonds is not involved, as that is a separate transaction on which gain or loss is separately computed.

In this case it is not the fact that the Respondent "had $137,521.30 where it had nothing before." The fact is that the Respondent had parted with $940,778.70 in cash and got in return nothing more than a book entry. No one knows if the bonds left outstanding will be paid at their face value. They are not due until 1938. By that time the Kirby Lumber Company may not have sufficient assets to pay the bonds at par. If it has not, the book entry showing this $137,521.30 certainly will be of no value to the Respondent or to any holder of bonds. As the record is silent on the fact as to whether the Respondent's promise to pay fifteen years hence was worth par in 1923 it cannot truthfully be said that the Respondent realized income from the transaction.

The best test of value is sales price so it must be assumed that the Respondent in this case paid only the actual value for the bonds purchased. That being true no income was realized.

The statement "Income may be realized from the gain resulting from fluctuations of corporate securities as well as from manual labor" is not true and no authorities can be supported to sustain it. The only time that income can be realized due to the fluc-

tuation in price of corporate securities is by their sale or conversion. Income cannot be realized by the purchase of corporate securities, which is the situation in the case at bar.

The "short selling" argument was vigorously advanced in the Kerbaugh-Empire case, *supra*, and definitely rejected. The Court states at page 175:

> "Plaintiff in error insists that in substance and effect the transaction was a 'short sale' of marks resulting in gain to defendant in error. But there is no similarity between what was done and such a venture. A short seller borrows what he sells, and the purchase price goes to the lender and is retained as security for repayment. The seller receives nothing until he repays the loan. Such a transaction would not meet the requirements of defendant in error. * * *"

POINT 2.

Admittedly the statute is comprehensive and covers income derived from "any source whatever." The statute, however, cannot tax something which is not income. As has been previously shown no income arose from the transaction here involved.

The argument with reference to the enactment of the revenue acts and the Commissioner's regulations is likewise without merit. The first of the cases decided on the point was filed with the Board of Tax Appeals April 9, 1925, argued June 18, 1925, and decided September 18, 1926. It is apparent, therefore, that Congress when enacting at least one of the statutes referred to was on notice that the tribunal established to review the acts of the Commissioner of Internal Revenue had decided against him on the

point here involved. By the time the Revenue Act of 1928 was passed at least six cases on the point had been decided. Failure of Congress to change the law might just as well be construed as approving the Board of Tax Appeals as the Commissioner. Weight is given to this suggestion by the fact that the Commissioner for years apparently acquiesced in the Board's decisions on the point as no appeal was taken to Circuit Courts until December 19, 1930. In any event, if no income was realized the mere re-enactment of a revenue statute will not make income.

Likewise if the transaction did not result in income the reenactment of regulations will not make it income.

The citations from authors on accounting to support the Government's argument that the regulation is in accord with common understanding and business practice actually tend to support the Respondent's position. Appendix B (page 23 Government's brief) quotes Gilman as stating:

> "Assuming that a reserve has been built up for the purpose of buying back bonds at 105 you will find that each purchase in the market at a less price will result in a profit which may very properly be credited to the interest account."

It is obvious that the reserve referred to had been built up by a charge to expense. It developed that too much expense had been so deducted from income in order to accomplish the purpose of the reserve. As too large an expense item had been deducted it is quite proper that the overdeduction be charged to profit. Apparently Dickinson had the same thought in mind.

It is thoroughly settled by accounting authorities that the purchase at more or less than par, and retirement of bonds by the corporation issuing them is a capital transaction. The difference between the purchase price and par must be charged to surplus, and not profit and loss. H. A. Finney, Professor of Accounting, Northwestern University, Editor of the Students' Department of the Journal of Accountancy, and manager of Haskins & Sells, Chicago, in his revised edition (1929) of "Principles of Accounting," Volume II, Chapter 46, page 13, states:

> "If they (bonds) are purchased at more or less than par and cancelled, the difference should be absorbed in Surplus. • • •"

POINT 3.

The authorities cited in the Government's brief do not "tend to support the Government's position."

In *Maryland Casualty Co. v. United States*, 251 U. S. 342, the casualty company in 1912 apparently overestimated the reserves to be set aside "with a resulting excessive deduction for that year from gross income • • •." (Page 352.) The money had actually been received by the taxpayer as premiums, so, in 1913, when the excess deduction for 1912 was discovered the Government quite properly held it was income in 1913. Even in this case of plain income, the Court showed that it sought to tax only real income and not mere bookkeeping entries, stating (page 353):

> "• • • Such deductions can be restored to income again only where it is clearly shown that

subsequent business conditions have released the amount of them to the free beneficial use of the company in a real, and not in a mere bookkeeping sense. * * *"

In other words, as in the case at bar, if the only profit was a bookkeeping entry there was no income.

Commissioner v. Simmons Gin Co., 43 Fed. (2d) 327, is one of the many cancellation of indebtedness cases. The Court held that the cancellation of the taxpayer's indebtedness did not result in income. The dicta wherein the Court "intimated" that the solvency of the taxpayer might affect the result is of no importance. It is interesting to note that in the Simmons Gin Company case the Government relied, unsuccessfully, upon Maryland Casualty Co. v. United States, which is the first case cited under Point 3 in the case at bar.

Charleston & W. C. Ry. Co. v. Burnet, 50 Fed. (2d) 342, is very similar to the Maryland Casualty Company case. In the Charleston Ry. Co. case the taxpayer believed it would have to pay certain wages which it believed employees had earned so set aside the said wages in a reserve account and deducted them from income. When it became apparent the wages would not be called for the amount thereof was credited to profit and loss. The real transaction is that the railway paid the then due wages to itself as trustee, found that they were not claimed so used them for its own purposes. In other words, the railway had erroneously charged itself with an expense which it was not obligated to pay. Clearly this is vastly different from the situation at bar where there could be no liability to pay until 1938, and, of course, no prior deduction from income.

Chicago R. I. & P. Ry. Co. v. Commissioner, 47 Fed. (2d) 990, presents the same situation as the case just discussed. The taxpayer deducted from income certain expense which it was not obligated to pay. The deduction should not have been taken, so its taxation was proper.

The argument on the Kerbaugh-Empire case is without merit as it does not discuss the vital point, *i. e.*, the question for decision which this Court stated to be (page 173):

> "The question for decision is whether the difference between the value of marks measured by dollars at the time of payment to the Custodian and the value when the loans were made was income."

CONCLUSION.

For the reasons stated the decision of the Court of Claims should be affirmed.

ROBERT ASH,
Attorney for Respondent,
Munsey Building,
Washington, D. C.

October, 1931.

Supreme Court of the United States

OCTOBER TERM, 1930.

No. 759.

THE UNITED STATES, *Petitioner*,

vs.

KIRBY LUMBER COMPANY.

MOTION TO REMAND TO COURT OF CLAIMS FOR FURTHER FINDINGS.

Comes now the Kirby Lumber Company by its attorney, Robert Ash, and moves that the above entitled cause be remanded to the Court of Claims with instructions to make a finding with reference to the consideration received by the Kirby Lumber Company for the bonds issued by it in 1923.

In June, 1923, the Kirby Lumber Company, issued $12,126,800 face value of bonds secured by a deed of trust on certain of its property. During 1923 the Kirby Lumber Company purchased $1,078,300 face value of the said bonds for $940,778.70, or $137,521.30 less than their face value, and retired them. The question for decision is whether the said $137,521.30 is income to the Kirby Lumber Company.

In the Court of Claims the case was tried on stipulated facts. The stipulation is correct as far as it goes. It states the bonds involved were issued at par, but does not state the consideration the Kirby Lumber Company received for them. The facts are that $11,526,800 in bonds, plus $9,776.94 in cash, were exchanged for preferred stock at the call price of $105 per $100 par value share plus accrued dividends of $126 per share, or a total of $231 for each $100 par value share of preferred stock. The remaining $600,000 of bonds were issued and placed in escrow to secure the payment of certain notes of the Kirby Lumber Company running to the Houston Oil Company. No cash was received for the bonds.

At the time the stipulation was entered into counsel believed that the consideration received for the bonds was immaterial as the transaction sought to be taxed was the purchase of bonds for less than their face value and their retirement. The language of the Court in *Burnet v. Sanford & Brooks Company*, 282 U. S. 359, however, indicates that the consideration received for the bonds may be material to the disposition of the case.

If the Court believes the consideration received for the bonds is material this motion should be granted and the case remanded to the Court of Claims for a finding on that point.

ROBERT ASH,
Munsey Building,
Washington, D. C.,
Attorney for Kirby Lumber Company.

May, 1931.

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CHARLES ELM

IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 26.

UNITED STATES, *Plaintiff in Error,*

vs.

KIRBY LUMBER CO., *Defendant in Error.*

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE AND BRIEF IN SUPPORT OF THE DECISION OF THE COURT OF CLAIMS.

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American Tobacco Company.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 26.

UNITED STATES, *Plaintiff in Error,*

vs.

KIRBY LUMBER CO., *Defendant in Error.*

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE.

May It Please the Court:

The undersigned as Counsel for The American Tobacco Company respectfully moves this Honorable Court for leave to file the accompanying brief in this case as Amicus Curiae.

J. MARVIN HAYNES,
Counsel for the American Tobacco Company.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 26.

UNITED STATES, *Plaintiff in Error,*

vs.

KIRBY LUMBER CO., *Defendant in Error.*

BRIEF OF THE AMERICAN TOBACCO COMPANY, AS AMICUS CURIAE, IN SUPPORT OF THE DECISION OF THE COURT OF CLAIMS.

PRELIMINARY STATEMENT.

The American Tobacco Company is a New Jersey Corporation. At various times during the years 1924, 1925 and 1927 the American Tobacco Company purchased some of its bonds, issued for cash at par, in the open market for cash at a price less than par. The Commissioner of Internal Revenue in his final

determinations of the American Tobacco Company's tax liability for the years 1924, 1925 and 1927 increased the Company's net income by the difference between the prices at which the bonds were issued by the Company and the price paid therefor by the Company upon their retirement. The Company appealed from this determination by the Commissioner of Internal Revenue to the Board of Tax Appeals, which sustained the Company's contention and found that the inclusion of the difference between the price at which the Company purchased its bonds and the price at which it issued them in the Company's income for the respective years was erroneous. The Commissioner has filed a petition for review to the United States Circuit Court of Appeals for the Second Circuit.

ARGUMENT.

I. No Income is Realized From the Purchase and Retirement of Bonds for an Amount Less than the Issuing Price.

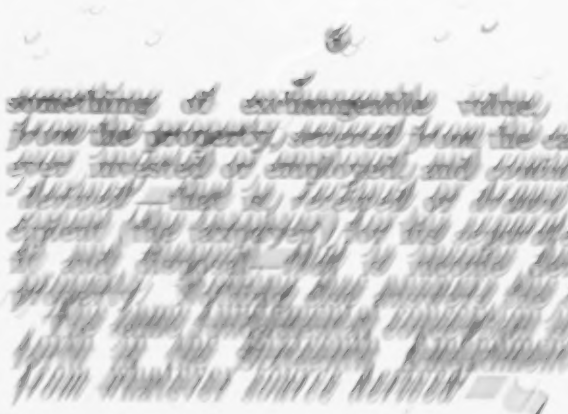
Most of the argument in this cause has been directed to the proposition that this case is controlled by the decision of this Court in *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170. We believe that this proposition is sound, and that the case can be shortly disposed of on that basis. But even if the *Kerbaugh-Empire* decision should be restricted to its peculiar facts, we submit that, under prior decisions of this Court, the decision of the Court of Claims should be affirmed. Since the application of the *Kerbaugh-Empire* decision to the facts herein has been ably developed by other counsel, this brief will be mainly di-

rected to the proposition that the prior decisions of the Court, of which the *Kerbaugh-Empire* decision was a particular application, establish that no income is realized from the purchase and retirement of bonds for an amount less than the issuing price.

The federal courts were early confronted with the question whether all *gains* are *income* within the meaning of the Sixteenth Amendment. If economists' definitions had been followed, the two terms would have been held to be synonymous. One of the best-known definitions of an economist declares income to be "the money value of the net accretion to one's economic power between two points of time". (Robert Murray Haig in The Federal Income Tax, Columbia University Lectures, p. 7)

In *Eisner v. Macomber*, 252 U. S. 189, the Court not only refused to accept the economist's conception of income, but laid down affirmatively an authoritative definition, and stated the tests by which it might be determined whether a particular gain was or was not income. After stating the well-known definition of income, the Court said:

> Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *'Derived—from—capital'*; 'The *gain—derived—from—capital'*, etc. Here we have the essential matter; *not* a gain *accruing* to capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit,



The emphasis here is upon the severance of the item under consideration. An increase in capital does not constitute income, as it would under an economist's definition. It must be separated or derived from capital, not a gain accruing to capital.

Again, in a preceding passage, the court stated another test for the determination of the meaning of the term income as used in the amendment:

> For the present purpose we require only a clear definition of the term income as used in common speech, in order to determine its meaning in the amendment. * * *

In other words, the term "income" as used in the Sixteenth Amendment bears that meaning which the people who adopted it would give the term; so the meaning which economists or other specialists may ascribe to it for their particular purposes

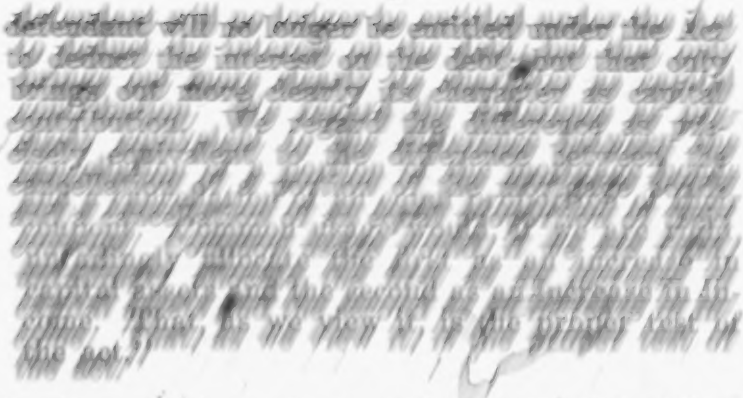
In the previous year, the federal circuit court of appeals in the Second Circuit had had to deal with a case quite similar to that herein. In *U. S. v. Oregon Washington R. R. & Nav. Co.*, 251 Fed. 211, a creditor of the defendant, which was also defendant's sole stockholder, released in its favor an indebtedness of

true [illegible]. The Government proceeded on the theory that the defendant had profited to the extent of $[illegible], as indeed it had, and that the fact was decisive. The court, per Lamar, J., held that this was not the meaning, saying:

> "However, the law, though it includes income from all sources, does not define income. Nor is the meaning of the word to be found in its lexicographical derivation. Its meaning is rather to be gathered from the implied assumptions of its use in common speech. The implied distinction, it seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital; i. e., wealth industrially employed in permanent form. It includes the earnings from a calling, as well as interest, royalties, or dividends, though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly accumulated to meet [illegible] and customarily be treated as the capital of the corporation [illegible]."

In the Oregon-Washington case, the creditor was the sole stockholder of the debtor, a fact which does not obtain in the instant case. But the court evidently rested its decision upon broader grounds, applicable herein, for it said:

> "The financial relief so given, will, it is true, be eventually reflected in the income, since the



In other words, a decrease in the capital obligations of a company, with a corresponding increase in its net worth, does not result in income to it. A cancellation of bonds does not give rise to income; by the same token, the retirement of bonds for less than the issuing price does not result in income. Both are essentially capital transactions, and do not fall within the term income as used in common speech.

This court again distinguished "gain" from "income" in *Edwards v. Cuba R. Co.*, 268 U. S. 628, decided a year previously to the *Kerbaugh-Empire* case. In that case, the Government of Cuba had granted certain subsidies of money and property to the Railroad. In consideration of such grants, the railroad agreed to construct certain lines, and to reduce its passenger and freight rates in certain specified instances. The collector, Edwards, urged that the subsidies were income to the Railroad, pointing both to the large gain in the Company's assets, and to the fact that the subsidies could be regarded as advance payments to the company in respect of the services for which reduced rates were to be given.

The court rejected these arguments, and held that the subsidies were not taxable income, for these reasons:

"The subsidy payments were appropriations to encourage the building of railroads, and were not profits or gains from the use or operation of the railroads. The subsidies were paid for the same purposes, it cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income. Neither the laws nor the contracts indicate that the money subsidies were to be used for the payment of dividends, interest, or anything else properly chargeable to or payable out of earnings or income. The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment. See *Stratton's Independence v. Howbert*, 231 U. S. 399, 415; *Eisner v. Macomber*, 252 U. S. 189, 207; *Merchants' Loan & Trust Co. v. Smietanka*, *supra* (255 U. S. 509)."

In this case, as in the *Oregon-Washington* case, the net worth of the company was greatly increased by the subsidies. The opinion states that in 1919 the payments "were transferred to the surplus account, and were used for capital expenditures." The company undoubtedly realized a "gain" during the years in question, since its assets increased with no corresponding increase in the liabilities. Yet it realized no taxable income, for the reason that the gain was a gain in capital assets, as in the *Oregon-Washington* case, and in the *Kerbaugh-Empire* case; a "growth in the investment," to use the terms of *Eisner v. Ma-*

comber, not "something of exchangeable value *proceeding from* the property, *severed from* the capital."

The same distinction was applied in the *Kerbaugh-Empire* case. The taxpayer therein had paid $80,000 in discharge of its note, for which some years previously it had received $724,000. The court held that no income to the taxpayer had resulted from the transaction, applying the definition and distinction of *Eisner v. Macomber*; that the transaction did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital. The decision accords with the analysis of *Eisner v. Macomber* and *Edwards v. Cuba R. Co.*; that, while the taxpayer realized a gain from the transaction, it was not such a gain as is commonly regarded as taxable income.

The principal case, as the Court of Claims and the Board of Tax Appeals have held in this and many like situations, is controlled by these decisions. As in the *Kerbaugh-Empire* case, the taxpayer herein received for its bonds an amount in excess of that which it had to pay to discharge them. Its balance sheet would thereby show a gain; its liabilities were reduced by $1,000,000, whereas its assets were reduced only $940,000. But this reduction of liabilities was not "severed from its capital" and "coming in"; it was rather a gain "accruing to capital", of the same sort as the cancellation of indebtedness in the *Oregon-Washington* case, the subsidies in the *Cuba R. Co.* case, and the retirement of the note in the *Kerbaugh-Empire* case—none of which were income.

This conclusion may be reinforced on the facts in another way. In the principal case, the bonds were retired in the same year in which they were issued.

Unless the financial situation of the obligor largely changed, therefore, which was not shown, it would appear that the obligor's ability to retire the bonds at less than the issuing price was due to an increase in the value of the dollar during the year. It is a commonplace that the federal income tax does not take account of fluctuations in the value of our own currency. For the same reason the taxpayer should not be compelled to pay an income tax on an essentially fictitious gain resulting from such a fluctuation in currency values. The term "income" as used in common speech clearly does not comprehend a gain of this character.

CONCLUSION.

For these reasons, it is respectfully submitted that the Court of Claims did not err in holding that the decision in *Bowers v. Kerbaugh-Empire Co.*, is controlling herein; and that no income is realized from the purchase and retirement of bonds for an amount less than the issuing price.

Respectfully submitted,

J. MARVIN HAYNES,
Counsel for the
American Tobacco Company.

SUPREME COURT OF THE UNITED STATES.

No. 26.—October Term, 1931.

The United States, Petitioner, vs. Kirby Lumber Company. } On Writ of Certiorari to the Court of Claims.

[November 2, 1931.]

Mr. Justice Holmes delivered the opinion of the Court.

In July, 1923 the plaintiff, the Kirby Lumber Company, issued its own bonds for $12,126,800 for which it received their par value. Later in the same year it purchased in the open market some of the same bonds at less than par, the difference of price being $137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923. By the Revenue Act of (November 23,) 1921, c. 136, § 213 (a) gross income includes "gains or profits and income derived from any source whatever", and by the Treasury Regulations authorized by § 1303, that have been in force through repeated reenactments, "If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year." Article 545 (1) (c) of Regulations 62, under Revenue Act of 1921. See Article 544 (1) (c) of Regulations 45, under Revenue Act of 1918; Article 545 (1) (c) of Regulations 65, under Revenue Act of 1924; Article 545 (1) (c) of Regulations 69, under Revenue Act of 1926; Article 68 (1) (c) of Regulations 74, under Revenue Act of 1928. We see no reason why the Regulations should not be accepted as a correct statement of the law.

In *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170, the defendant in error owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment the marks had fallen in value, which so far as it went was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the con-

tention was denied. Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 364.

Judgment reversed.

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Test:

Clerk, Supreme Court, U. S.